Who Gets A Dead Man's Gold? The Dilemma of Lottery Winnings Payable to a Decedent's Estate

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NOTE

WHO GETS A DEAD MAN'S GOLD? THE DILEMMA OF LOTTERY WINNINGS PAYABLE TO A DECEDENT'S ESTATE

Act I.

"Your dad called today. He finally found that lottery ticket he misplaced."

"That's great. At least we won't have to worry anymore about being bankrupted by nursing home bills."

Act II.

"Hon, it's the hospital. We'd better get there fast. Your dad's taken a turn for the worse."

Act III.

"Hon, it's that IRS man again. If we don't come up with the money within thirty days, they're going to start foreclosure on the house and attach our savings account."

I. STATEMENT OF THE PROBLEM

A. *Scope of Analysis*

This article addresses the federal estate tax and federal income tax consequences of lottery winnings which flow to the estate of a decedent or, alternatively, directly to the decedent's beneficiaries. State income tax and state death tax considerations must also be taken into account. With respect to these secondary implications, this article draws largely upon the Code

of Virginia and the relevant sections of Virginia's income tax and estate tax statutes. Some references will be made to the possibility of contrary statutory treatment in other states, but primary reliance will be upon Virginia law.

B. *The Problem As Defined by NAASPL*

Under present IRS policy, the abbreviated scenario depicted above is a dramatized reminder of the potential pitfalls awaiting the euphoric but unwary family members of a lottery winner.

The current policy is to treat lottery winnings payable to the estate of a decedent over a number of years as an annuity, and to assess estate taxes based on the commuted value of the future payouts.[1] The potential liability of individual beneficiaries is illustrated by the following example proffered by the North American Association of State and Provincial Lotteries (NAASPL).[2]

Assume that an unmarried taxpayer purchases a one dollar lottery ticket that wins a $20 million jackpot, payable in annual installments of one million dollars over twenty years.[3] Assume further that the taxpayer's luck ran out and he died due to an accident after receiving the first payment. The heirs grieve, but are comforted by the knowledge that they are now wealthy. At probate, they accept the assets of the estate, which are negligible except for the lottery winnings. Their first unpleasant surprise is a notice from the IRS that the present value of the future revenue stream of $19 million in lottery winnings is $9.5

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1. *See generally* Letter from Paul F. Kugler, Assistant Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service, to William S. Bergman, Executive Director, North American Association of State and Provincial Lotteries (May 6, 1992) (on file with author) [hereinafter Kugler]; Letter from Kenneth W. Thorson, Director, Virginia Lottery, to Fred Goldberg, Assistant Secretary for Tax Policy, U.S. Treasury Department (March 11, 1992) (on file with author) [hereinafter Thorson]; *Analysis of IRS Tax Position on Estates of Decedents Who Are Lotto Jackpot Prize Winners Whose Prizes Are Paid Over Time*, (N. Am. Ass'n of State and Provincial Lotteries) (undated) (on file with author) [hereinafter NAASPL Analysis].

2. *See* NAASPL Analysis, *supra* note 1, at 3-5.

3. *See* Virginia State Lottery Dept. Reg. VR 447,-02-2, § 3.33 (1992); Virginia Lottery Director's Order 32(90), ¶ 14 (October 31, 1990).

million and the estate tax on this amount is approximately $5.225 million.[4]

This initial tax liability is only the beginning of the newly "wealthy" heirs' troubles. Unless they possess other assets with which to pay the taxes owed, they will be delinquent nine months after the taxpayer's death.[5] The first installment of one million dollars from the lottery will be available to the heirs, but will fall far short of the $5,225,000 due.

Once the estate is delinquent, the IRS assesses a monthly penalty of one-half of one percent per month, up to a maximum penalty of twenty-five percent.[6] In dollar terms, the monthly penalty of $26,125 could aggregate to a maximum of $1,306,250.[7]

In addition to the tax liability and the monthly-accruing penalty, the IRS assesses interest on *both* of these amounts[8] at the federal short-term rate plus three percentage points.[9] Be-

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4. *See* Treas. Reg. § 20.2031-7 (1984) (as modified by I.R.S. Notice 89-60, 1989-1 C.B. 700). This regulation, as modified, specifies that the commuted value of annuities and similar interests shall be computed based on an interest rate equal to 120% of the applicable federal midterm rate for the month of valuation. For the month of June 1993, this rate, based on annual compounding, was 6.41%. Rev. Rul. 93-39, 1993-22 I.R.B. 5 (Table 1). Under the provisions of I.R.C. § 7520(a)(2) (1992), this figure is to be rounded to the nearest two-tenths of one percent, or 6.4%. In computing their example, NAASPL used interest rates in effect in 1992 and an estate tax rate of 55%. I.R.C. § 2001(c)(2)(D) (1992). NAASPL also disregarded as insubstantial the effect of any credits, exclusions, exemptions or deductions. Since these computations were derived, interest rates have declined and the maximum federal estate tax rate dropped to 50% (disregarding the effective marginal rate increase for estates over $10 million due to the phaseout of the $600,000 unified credit equivalent for estates exceeding that level). The 1993 tax package restored the previous maximum rate of 55%, for estates exceeding $3 million. *Special Supplement: A Tax Bill Baedeker—A Guide to the 1993 Tax Law*, 60 TAX NOTES 809, 828 (1993) (citing Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,208), 107 Stat. 312, 469 (1993) [hereinafter *Baedeker*].

5. *See* I.R.C. § 6075(a) (1993). Pursuant to I.R.C. § 6161(a) (1993), the Secretary of the Treasury may extend the time for payment for up to 12 months. Additionally, IRS District Directors have discretionary authority to extend the time for payment by "entering into an installment agreement with the estate." Kugler, *supra* note 1, at 1.

6. *See* I.R.C. § 6651(a)(2) (1993).

7. *See* NAASPL Analysis, *supra* note 1, at 4.

8. *See* I.R.C. § 6601(a), (e)(2)(A) (1993).

9. *See* I.R.C. § 6621(a)(2) (1993). Pursuant to I.R.C. § 6621(b)(3) (1993), the federal short-term rate for any given month shall be rounded to the nearest full percent, or, if a multiple of one-half of 1%, to the next highest full percent. Using the short-term rates in Table 1 of Rev. Rul. 93-39, 1993-22 I.R.B. 5, the rate for June 1993

cause of the additional penalty each month that the tax is de-
linquent and the compounding of the interest on the tax and
cumulative penalties, the monthly *increase* in the amount owed
the IRS grows each month. If no payments are made, the liabil-
ity will increase by more than $900,000[10] by the end of the
first year. By the fiftieth month (when penalties are capped at
twenty-five percent), the monthly rate of increase in the
amount owed is $85,755, or $1,029,060 annually.[11] At that
point, with no additional penalties being imposed, the monthly
increase in the tax bill is "only" $59,869, or $718,437 per
year.[12] "At all times, the amount of annual *increase* for penalty
and interest exceeds the after-tax income from the annual,
future jackpot payments."[13]

C. *A Second Look at the Problem*

The NAASPL example arguably overstates the magnitude of
the problem. There are four adjustments to the NAASPL exam-
ple which, although not universally applicable, would serve to
ameliorate the liability for most estates. A fifth possible adjust-
ment, based on lower interest rates[14] in 1993, will not be dis-
cussed, due to the probability that 1993 rates were atypically
low and would likely rise in the long term. The other four ad-
justments are: (1) discounting the future stream of payouts,
both for present value and illiquidity, (2) inclusion of the
$600,000 estate/gift tax exemption, (3) the likelihood of penalty
waivers and (4) application in full of the $1 million annual
payouts to liquidation of the estate's tax liability.

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would be 4% plus the 3% add-on for a total interest rate of 7%. Pursuant to I.R.C. §
6622 (1993), interest is compounded daily. Again, the NAASPL computations were
based on interest rates in effect in 1992.
    10. *See* NAASPL Analysis, *supra* note 1, at 4.
    11. *Id.*
    12. *Id.*
    13. *Id.* at 4-5 (emphasis added).
    14. Lower interest rates work in the opposite direction, creating a higher present
value and a correspondingly higher tax liability. For example, the annuity factor
applicable in September 1992, based on an interest rate of 7.2%, was 10.1824 for a
nineteen year annuity. By June 1993, the interest rate had dropped to 6.4%. *See* Rev.
Rul. 93-39, *supra* note 4. The annuity factor was 10.8174. *Actuarial Values, Alpha
Volume*, I.R.S. Pub. No. 1457 (8-89), at 3-11, 3-13.

Discounting property in an estate due to its illiquidity or restrictions on its transfer is well-accepted in estate and gift tax law. The section of the Virginia State Lottery Law dealing with the right of assignment, rewritten in 1992, provides that "[n]o right of any person to a prize drawn shall be assignable . . . ."[15] The statute goes on to list three exceptions: transfer to a designated beneficiary at the winner's death, transfer to the deceased winner's estate absent a designated beneficiary, and transfer to another pursuant to a court order.[16] These exceptions are exclusive—no other transfers are permitted, thereby prohibiting post-mortem transfers by designated beneficiaries or heirs of the estate. If the rights to the future payouts were freely transferable, the market would establish a value, presumably the discounted or present value of the future income. The fact that these rights are, by statute, not transferable, does not mean that they have no value. Their value in the hands of the holder is, by analogy to well-established law applicable to property such as large blocks of securities or closely held corporations, discounted due to the impediments to their transfer.

If the estate contains an unusually large block of stock, such that its liquidation could not be accomplished within a reasonable time without depressing the market price, valuation for estate tax purposes will be made by alternative methods, such as the price commanded by sale through an underwriter.[17] The valuation of shares in closely held corporations held by an estate is accorded special treatment. Where most or all of the shares of a corporation are held within a family, there is effectively no market from which to derive a price. In such a situation, the Service has indicated a willingness to examine a number of factors in order to reach a surrogate for the fair market value.[18] Valuation of such properties in an estate is more art

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15. VA. CODE ANN. § 58.1-4013(A) (Repl. Vol. 1991 & Cum. Supp. 1993).

16. *Id.*

17. *See* Treas. Reg. § 20.2031-2(e) (1992). *See also* Rev. Rul. 83-30, 1983-1 C.B. 224 ("blockage discount" considered when valuing large block of stock sold through an underwriter).

18. *See* Rev. Rul. 59-60, 1959-1 C.B. 237, *modified by,* Rev. Rul. 65-193, 1965-2 C.B. 370 *and amplified by,* Rev. Rul. 77-287, 1977-2 C.B. 319 (1977), Rev. Rul. 80-213, 1980-2 C.B. 101, Rev. Rul. 83-120, 1983-2 C.B. 170 (listing eight factors to be considered). *See also* Estate of Andrews v. Commissioner, 79 T.C. 938, 951-57 (1982)

than science and will normally depend on the facts of each case. Valuation of properties having no ready market is "inherently imprecise and capable of resolution only by a Solomon-like pronouncement."[19] Because of the fact-specific nature of the problem, "each case necessarily turns on its own particular facts."[20] To the best of this writer's knowledge, the question of the present valuation of a revenue stream of lottery payouts payable over time would be one of first impression. The present value is clearly greater than zero, but since the rights to the income stream are not alienable, it could hardly be argued that the value is that derived from government annuity tables. It would appear that resolution of this question rests with the "Solomon-like" wisdom of the courts.

The second adjustment, the $600,000 exemption, or the $192,800 unified credit, is fully available only if it has not been previously used as a shelter against gift taxes or is not currently needed as a shelter against taxes imposed on other assets in the decedent's gross estate. Thus, some estates will not be able to use the exemption to shelter lottery winnings. Some estates will be able to use the exemption, but not to its full extent, while others will be able to exploit it fully to shield part of the lottery winnings. For the purpose of analysis, we will assume full use of the exemption.

The third adjustment concerns the likelihood that, upon proper application to the Service, penalties will be waived. Upon a showing of reasonable cause, the IRS may grant an extension of the time allowed for payment of up to twelve months. Further extensions may be granted for periods up to ten years from the original due date in cases of "undue hardship."[21]

(discount from Commissioner's valuation due to lack of marketability expressed in dollars but equating to 42.6%); Estate of Piper v. Commissioner, 72 T.C. 1062, 1084-86 (1979) (35% discount allowed on valuation of stock due to private placement necessitated by lack of marketability).
  19. Messing v. Commissioner, 48 T.C. 502, 512 (1967), acq. 1968-2 C.B. 2 (valuation dispute in gifts of shares in a closely held corporation).
  20. Id.
  21. I.R.C. § 6161(a)(2) (1993). "Reasonable cause" justifying an extension is demonstrated when:
      [a]n estate is comprised [sic] in substantial part of assets consisting of rights to receive payments in the future (i.e. annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due

The final adjustment is the full application of each year's $1 million payout to liquidation of the tax liability. If the initial payout were largely or fully intact, the tax liability could be immediately reduced by as much as $1 million.[22] By applying these four adjustments to the NAASPL example of $19 million in future payouts, the drastic effects described in part I(B) can be significantly ameliorated.

D. *A Twenty Year Analysis*

In the fall of 1992, NAASPL more closely examined the example described in part I(B). In a portion of that analysis, three of the four adjustments outlined in part I(C) were incorporated. The adjustment based on discounting for inalienability and illiquidity was not employed. The relevant results of that in-depth examination are reproduced here as Tables 1 and 2.[23]

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and the estate cannot borrow against these assets except upon terms
which would inflict loss upon the estate.
Treas. Reg. § 20.6161-1(a)(1) (1992) (example (2)).

22. The Lottery Department would, of course, withhold income taxes on the $1 million payout, but since this example assumes that the entire amount will be used to pay taxes, the effect is of no consequence. The estate will be liable for both estate and income taxes; the amount paid as estate tax can be deducted against the estate's income tax. These relationships will be explored more fully in part I, sections (D) and (F). *See infra* text accompanying notes 23-42, 50-65.

23. *See generally The Death of a Lottery Recipient: Problems and Suggested Solutions*, Memorandum from Marvin Winick & Douglas E. Gross, of Brown, Winick, Graves, Donnelly, Baskerville and Schoenebaum, Des Moines, Iowa to NAASPL (Oct. 1, 1992) [hereinafter Winick memo] (on file with author).

Table 1

ASSUMPTIONS

Annual Death Tax Payments = 10% of Total Adjusted Death Taxes.
Interest rate on unpaid death taxes remains constant at 8%
Death tax computation is amended annually to reflect interest deductions.
Marginal death tax rate remains constant at 55%
State/Provincial death tax equals the federal tax credit for state death taxes.
State/Provincial death tax can be paid on the same terms as federal estate tax.

DEATH TAX CALCULATION	Initial Calculation	Final Calculation
1992 Lottery Proceeds (after income taxes)	650,000	650,000
Present Value of Remaining 19 Lottery Payments	10,363,737	10,363,737
Interest Deduction	0	-1,712,638
Taxable Estate	11,013,737	9,301,099
Tentative Tax	5,698,355	4,756,405
Unified Credit	-192,800	-192,800
State Death Tax Credit	-1,228,998	-961,367
Federal Estate Tax	4,276,557	3,602,238
State Death Tax	1,228,998	961,367
Total Death Taxes	5,505,555	4,563,605

DEATH TAX PAYMENT SCHEDULE

Year	Total Adjusted Death Taxes	Annual Death Tax Payments	Interest	Total Payments	Cumulative Death Tax Payments	Unpaid Balance of Death Taxes
1992	0	0	0	0	0	0
1993	5,505,555	550,556	0	550,556	550,556	4,955,000
1994	5,287,535	528,754	396,400	925,154	1,079,309	4,208,226
1995	5,102,373	510,237	336,658	846,895	1,589,546	3,512,827
1996	4,947,809	494,781	281,026	775,807	2,084,327	2,863,482
1997	4,821,816	482,182	229,079	711,260	2,566,509	2,255,307
1998	4,722,582	472,258	180,425	652,683	3,038,767	1,683,815
1999	4,648,494	464,849	134,705	599,555	3,503,617	1,144,878
2000	4,598,120	459,812	91,590	551,402	3,963,429	634,691
2001	4,570,193	457,019	50,775	507,795	4,420,448	149,746
2002	4,563,605	143,157	11,980	155,136	4,563,605	0
Totals		4,563,605	1,712,638	6,276,242		

Table 2

ASSUMPTIONS

Combined federal and state/provincial income tax rate remains constant at	35%
Estate tax deduction for income tax purposes (total federal tax / 19) =	189,591
After-tax rate of return on invested net lottery proceeds =	6%

NET PROCEEDS AVAILABLE TO LOTTERY WINNER

Year	Gross Lottery Proceeds	Annual Income Tax Payments	Annual Death Tax Payments	Interest	Net Lottery Proceeds	Future Value of Net Proceeds
1992	1,000,000	350,000	0	0	650,000	1,966,640
1993	1,000,000	283,643	550,556	0	165,801	473,254
1994	1,000,000	283,643	528,754	396,400	-208,797	-562,242
1995	1,000,000	283,643	510,237	336,658	-130,538	-331,614
1996	1,000,000	283,643	494,781	281,026	-59,450	-142,476
1997	1,000,000	283,643	482,182	229,079	5,097	11,524
1998	1,000,000	283,643	472,258	180,425	63,674	135,813
1999	1,000,000	283,643	464,849	134,705	116,802	235,029
2000	1,000,000	283,643	459,812	91,590	164,955	313,133
2001	1,000,000	283,643	457,019	50,775	208,562	373,503
2002	1,000,000	283,643	143,157	11,980	561,221	948,170
2003	1,000,000	283,643	0	0	716,357	1,141,764
2004	1,000,000	283,643	0	0	716,357	1,077,136
2005	1,000,000	283,643	0	0	716,357	1,016,166
2006	1,000,000	283,643	0	0	716,357	958,647
2007	1,000,000	283,643	0	0	716,357	904,384
2008	1,000,000	283,643	0	0	716,357	853,193
2009	1,000,000	283,643	0	0	716,357	804,899
2010	1,000,000	283,643	0	0	716,357	759,338
2011	1,000,000	283,643	0	0	716,357	716,357
Totals	20,000,000	5,739,217	4,563,605	1,712,638	7,984,541	11,652,620

The tables depict the tax consequences of winning a $20 million dollar jackpot on July 1, 1992, collecting the initial $1 million dollar installment on that same date, and then dying on September 30, 1992. The tables also reflect a request by the estate's executor for a ten-year extension of the time in which to pay the tax pursuant to I.R.C. § 6161(a). Table 1 focuses on satisfaction of the estate tax liability over the ten year period 1993-2002, showing the effect of interest paid on the outstanding balances and the deduction of that interest as an expense of

administering the estate. Table 2 addresses the income tax liability of the estate over the entire twenty year payout period, and shows the effect of deducting the estate taxes paid during the years 1993-2002 against the income tax liability for those years. A more detailed discussion follows.

The assumptions made are shown at the top of each table. In Table 1 the present value of annual lottery payouts of one million dollars for nineteen years is $10,363,737.[24] Estate taxes are paid over ten years pursuant to I.R.C. § 6161(a). It should be noted that the statutory language is discretionary. "The Secretary *may*, for reasonable cause, extend the time for payment . . . ."[25] The estate tax liability is recomputed each year during the ten year period to reflect the deduction for interest actually paid.[26] For example, the interest actually paid in 1994 would be a deduction against that year's taxes. At a 55% rate, the $396,400 in interest payments would yield a tax savings of $218,020 against the $5,505,555 tax otherwise due, resulting in a restated tax for the year of $5,287,535.

The interest rate on the unpaid tax balances is assumed to be a constant eight percent.[27] In fact, the interest rate is subject to quarterly variations[28] and must be recomputed each time an annual interest payment is made. The federal estate tax rate is assumed to remain constant at 55%. The maximum federal estate tax rate declined to 50% in 1993, but reverted to its former level with the 1993 tax bill.[29]

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24. The relevant interest rate (120% of the applicable federal mid-term rate) for September 1992 was 7.19%. *Id.* at 8. This figure is rounded off to the nearest two-tenths of one percent (or 7.2%) and is used in the annuity tables in I.R.S. Publication 1457. At an interest rate of 7.2%, the annuity factor for 19 years is 10.1824, which for a $1 million annuity would yield a valuation of $10,182,400. The factor for 20 years is 10.4313, which would yield a valuation of $10,431,300. The valuation actually used by Winick and Gross, $10,363,737, is approximately three-fourths of the difference between the lower (19 year) valuation derived from the annuity table and the higher (20 year) valuation.

25. I.R.C. § 6161(a) (1993) (emphasis added).

26. *See* Rev. Rul. 81-256, 1981-2 C.B. 183 (interest expense incurred is deductible under I.R.C. § 2053(a)(2)).

27. The interest rate for June 1993 was seven percent. The September 1992 rate was also seven percent. *See supra* note 9. *See* Winick memo, *supra* note 23, at 9.

28. *See* I.R.C. § 6621(b)(2)(A) (1993).

29. *See supra* note 4.

The remaining assumptions for Table 1 deal with state death taxes, the credit they receive against the federal estate tax, and the payment terms associated with them. The starting point for this discussion is the federal estate tax code. The Code provides that estate or similar taxes actually paid to a state government shall, within limitations, be credited against federal estate taxes otherwise payable. The credit schedule ranges from eight-tenths of one percent for small estates to sixteen percent for estates exceeding $10,040,000.[30] If a state's death tax does not exceed the percentage amounts in the federal credit schedule, the entire amount of the state tax actually paid will be credited against the federal estate tax. The death tax laws vary from state to state. The language of the Virginia Estate Tax Act is keyed to the federal Code. For estates of Virginia residents, the Virginia estate tax is imposed "in the amount of the federal credit . . . ."[31] For estates of nonresidents, the Virginia estate tax is expressed as a fraction of the federal credit, imposing the Virginia tax on that percentage of the estate subject to the jurisdiction of the Virginia Estate Tax Act.[32] Since neither section of the Virginia statute imposes an estate tax exceeding the federal credit, the Virginia tax is fully offset by a corresponding credit to the federal estate tax. In Table 1, the state death tax is shown as a positive number, while the (federal) state death tax credit is shown as an offsetting negative figure. In the initial calculation, the state death tax rate comes to 11.16%, while in the final calculation, the rate is 10.34%. This variation reflects the graduated brackets in the federal credit schedule, with the larger taxable estate in the initial calculation being subject to higher marginal rates. The language of the Virginia statute is also in harmony with the federal Code with respect to payment terms and extensions. "If the personal representative has obtained an extension of time for . . . paying the federal estate tax . . . , the . . . payment required by subsection C shall be similarly extended . . . ."[33] Thus, payments of the Virginia estate tax may also be made over a period of ten years, if

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30. *See* I.R.C. § 2011(a)-(b) (1993).
31. VA. CODE ANN. § 58.1-902(A) (Repl. Vol. 1991).
32. *Id.* § 58.1-903(A).
33. *Id.* § 58.1-905(B).

such permission is obtained with respect to the federal estate tax.

An initial and a final calculation are necessary since the taxable estate and the corresponding death taxes (federal and state) will drop with each deduction for interest paid. The initial projection, with no deduction for interest, is for total estate (death) taxes of $5,505,555. The final calculation, with deductions taken for $1,712,638 in interest, is for total estate taxes of $4,563,605. The profile at the bottom of Table 1 simply depicts the impact of these relationships on an annual basis. As can readily be seen, the final adjustment in the year 2002 yields a total death tax liability of $4,563,605. The sum of the annual death tax payments aggregates to $4,563,605 as well, and the cumulative death tax payment figure in the year 2002 mirrors this number.

Table 2 describes the combined effects of the annual death tax and interest payments in the ten years 1993-2002, as well as the annual income tax payments in the entire twenty year period (1992-2011). Income accruing to an estate is taxable[34] "in the same manner as in the case of an individual . . . "[35] but at special rates prescribed for estates and trusts.[36] Income earned by the decedent before his death, and flowing to his estate or directly to his designated beneficiaries after his death, is considered income in respect of a decedent ("IRD")[37] and is subject to federal income tax under I.R.C § 61(a)(14). The subject of income in respect of a decedent is discussed at some length in part I(F). For the purpose of understanding Table 2, it is only necessary to recognize that the flow of income after a decedent's death, attributable to the decedent's efforts before his death, is considered taxable income for federal income tax purposes in the year it is actually received.

The assumptions used in Table 2 include a 35% combined federal and state income tax rate. The new maximum federal

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34. *See* I.R.C. § 641(a) (1993).
35. *Id.* § 641(b) (1993).
36. *See id.* § 1(e) (1993). In both the pre- and post-1993 tax schedules; the maximum marginal rate for estates and trusts with taxable income exceeding $9,900 was 31%. *Id.*
37. *See generally id.* § 691 (1993).

rate is 39.6%. Virginia imposes an income tax on estates and trusts[38] at the same rates as for individuals.[39] The combined maximum federal/state income tax for Virginia estates (and individuals) is thus 45.35%.[40]

Table 2 also assumes that the deduction for the federal estate tax paid will be applied against the federal income tax liability over the nineteen years (1993-2011) that jackpot payouts are made to the estate or to designated beneficiaries.[41] The final assumption used in Table 2 is the immediate investment of any net lottery proceeds in an instrument earning after-tax income of six percent.[42]

The real lesson to be derived from Table 2 is that the estate begins to experience a positive cash flow in 1997, after three years of deficits. (The cash flow is momentarily positive in 1993 since interest payments are not due until 1994.) Estate taxes are completely liquidated after ten years (2002) and interest payments are no longer required after the estate taxes are paid. Over the twenty-year period of lottery payouts, the net proceeds after payment of all taxes and interest aggregate to $7,984,541. The deficits for the three years 1994-96 total $398,785. While this deficit is not addressed in the Table 2 model by additional

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38. *See* VA. CODE ANN. § 58.1-360 (Repl. Vol. 1991).

39. *See id.* § 58.1-320. The maximum rate of 5.75% begins at annual taxable income exceeding $17,000.

40. The maximum marginal income tax rates for estates and trusts were increased in the 1993 Omnibus Budget Reconciliation Act (OBRA 1993) to parallel the increase in individual rates. The brackets, however, are considerably lower than those for individuals. The 36% rate applies to estate or trust income from $5,501 to $7,500. The 39.6% rate applies to all estate or trust income exceeding $7,500. *See Baedeker, supra* note 4, at 815 (citing OBRA '93, §§ 13,201-05). Thus, Virginia estates with taxable income exceeding $17,000 are subject to the maximum Virginia rate, or 5.75%, and the maximum federal rate, or 39.6%, for a combined rate of 45.35%.

41. *See* I.R.C. § 691(c)(1)(A)-(B) (1993). The deduction for federal estate taxes paid may be allocated ratably over the years when the income is actually received. The total federal estate tax paid (final calculation) as shown in Table 1 is $3,602,238. Allocating this amount over 19 years yields a deduction of $189,591 for each year. After subtracting this deduction from the annual payout of $1,000,000, the annual taxable income is $810,409. At a 35% tax rate, the annual income tax liability is $283,643. The income tax due in 1992, of course, reflects no such deduction, and the full $1,000,000 is subject to the 35% tax rate.

42. At 1993 interest rates, an investment earning six percent in after-tax income would probably be considered risky and beyond the reach of a prudent fiduciary. This assumption affects only the last column in Table 2, Future Value of Net Proceeds, and is, anyway, another story.

borrowing, it should be noted that the positive cash flow in the years 1992-93 totals $815,801.[43] In summary, the estate of a deceased lottery winner need not present an insoluble dilemma to the decedent's estate or beneficiaries. Properly managed, the problem can be resolved without bankrupting the estate, and the beneficiaries can even realize an after-tax and after-expenses total of almost $8 million. Having resolved the financial aspects of this issue, there remains the question of whether this treatment is legally correct. We now turn our attention to the legal questions.

E. *The IRS Position—Treat As Annuity Pursuant to § 2039*

When asked to comment on the problems confronting the estate of a lottery winner—a large tax bill due to the present value calculation, but relatively meager funds currently available—the Service's response was predictably not very satisfying:

> The Internal Revenue Code specifically provides that the decedent's gross estate would include the present value of the right to receive all installments that had not been paid prior to the date of death. Inclusion in the gross estate is required whether the installments are payable to the probate estate or to a person who was designated by the jackpot winner before death. The present value of an installment obligation, *including installments payable by a state lottery*, is calculated by discounting each future installment payment at the interest rate authorized under the Code that is in effect for the month the decedent dies.[44]

The analysis prepared for NAASPL in October 1992 notes that the IRS "will require that the future lottery payments be included in the gross estate pursuant to IRC § 2033 or the IRS may alternatively take the position that the future lottery pay-

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43. The net proceeds in 1992 are, of course, beyond the control of the executor or the beneficiaries, at least during the period prior to the decedent's death. One would hope that at least some portion of the after-tax income in 1992 would remain intact. The net proceeds in 1993 are either controlled by the executor or, if paid directly to a beneficiary, subject to recovery by the executor in a civil judgment proceeding.

44. Kugler, *supra* note 1, at 1 (emphasis added).

ments is [sic] an annuity which should be included in the gross estate pursuant to IRC § 2039."[45]

IRC § 2033 is the general taxing section of the estate tax code: "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."[46] Other, more specific sections of the Code, take precedence where they are applicable. Thus, IRC § 2039, Annuities, provides such statutory authority as exists for treating future lottery payouts as an annuity:

> The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement . . . if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.[47]

As previously discussed, the valuation of the annuity included in the decedent's gross estate is its discounted present value.[48] The Code and the Regulations are silent, however, with respect to the threshold question of whether a future revenue stream of lottery winnings is properly characterized as an annuity. The Kugler memo asserts that it is, but does so without citing a specific Code section or Regulation because, in fact, there are none. Kenneth W. Thorson, Director of the Virginia Lottery, believes that the Service makes its assertion based on the fact that a revenue stream of lottery payments for a fixed number of years "looks like" an annuity arrangement. He believes that the Service, having seized upon an analogous "lookalike," refuses to recognize the inherent differences involved and chooses to ignore the total absence of statutory or case law authority for inclusion of lottery proceeds in the annuity classification.[49]

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45. Winick memo, *supra* note 23, at 5.
46. I.R.C. § 2033 (1993).
47. I.R.C. § 2039(a) (1993).
48. *See* Treas. Reg. § 20.2031-7 (1984).
49. Interview with Kenneth W. Thorson, Director, Virginia Lottery, in Richmond,

Perhaps the most fundamental flaw in treating lottery winnings as an annuity is the fact that the lottery winnings are not alienable or assignable, while an annuity generally is.[50] The beneficiaries of a commercial annuity can, if necessary, sell the annuity for its discounted present value, pay the estate tax owed, and then reinvest what is left in another annuity or possibly a different financial instrument. No such option is available to Virginia beneficiaries of a deceased lottery winner. Because the right to future payouts is not transferable, the present value calculation is largely meaningless. As previously discussed in part I(D), the tax problem can be managed. This does not alter, however, the essential unfairness of levying a tax upon a property right that, for practical purposes, cannot be liquidated at all, much less for a value anywhere near the value assigned for taxation purposes.

F. An "Unofficial" IRS Position—Treat as IRD under § 691

There is a "minority view" within the Service which believes the official, annuity-like characterization is erroneous.

> At least one IRS *income* tax official has suggested that the income to the estate should be classified as income in respect of a decedent (IRC § 691) and that his colleagues in *estate* tax are incorrect in including the present value of the entire future stream of prize payments in the gross estate for estate tax purposes. According to this view, nothing would be included in the gross estate for *estate* tax purposes.[51]

This "minority view" is only partially correct. The income stream of future lottery payouts will be treated as income in respect of a decedent and accordingly subjected to income taxa-

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Va. (July 28, 1993).

50. Although this is the general rule, there are exceptions. Employer-provided annuities, for example, are normally intended as a benefit and as income security to the employee and his surviving spouse, and may contain provisions barring their sale or assignment by the employee's successor in interest.

51. NAASPL Analysis, *supra* note 1, at 5.

tion.[52] However, treatment as IRD assumes that the property right giving rise to the income has previously been taxed in the decedent's estate, and a deduction is expressly allowed for this prior payment of estate taxes.[53] The "minority view" is thus patently incorrect in asserting that "nothing would be included in the gross estate for *estate* tax purposes."[54] However, the anonymous official expressing the "minority view" does reach the heart of the issue in his contention that the inclusion of the present value of the entire future revenue stream in the gross estate is erroneous.

At this point in our analysis, it seems beyond dispute that lottery payouts received after the decedent's death are income in respect of a decedent and are subject to income taxation in the year actually received. It is equally indisputable that these payments must be included in the decedent's estate and subjected to the federal estate tax (with subsequent, ratable deductions against the future payouts subject to income taxes). The unanswered question is how the stream of future payouts should be valued for estate tax purposes. It would perhaps simplify matters to permit the executor to keep the estate open for the duration of the payouts (up to nineteen years for our purposes), filing amended estate tax returns each year to reflect the actual amounts flowing to the estate, rather than a discounted present value rendered highly speculative by the illiquidity of the rights to those payments. However, such an approach is apparently frowned upon.[55]

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52. *See* I.R.C. § 61(a)(14) (1993).
53. *See* I.R.C. § 691(c) (1993).
54. NAASPL Analysis, *supra* note 1, at 5.
55. There is fairly strong authority for this proposition:

> Claims are obviously difficult to value if they are unliquidated in amount or subject to defenses, but this does not put them beyond the reach of § 2033. Moreover, there is no room in the estate tax area for the "open transaction" principle that sometimes permits taxpayers to postpone the recognition of income when they receive property of indeterminate value. To avoid imposing the income tax on the basis of "mere estimates, assumptions and speculation," the Supreme Court held in *Burnet v. Logan* that the reporting of gain or loss on a sale for a contingent deferred price can be deferred until the price is reduced to money or can be valued with reasonable accuracy. In so holding, however, the Court distinguished between the income tax, which is levied annually and therefore can tolerate delay, and the estate tax, where "some valuation—speculative or otherwise—[is] necessary in order to close the estate.

Before addressing the question of valuation in more depth, it may be helpful to the reader to give a short exposition of the history and substance of I.R.C. § 691, Recipients of Income in Respect of Decedents. Prior to 1934, income due but not received by cash basis decedents prior to death escaped income taxation.[56] The 1934 Act equalized the tax treatment of cash basis and accrual basis taxpayers,[57] but the Act, and subsequent Supreme Court and lower court decisions had the effect of bunching or "pyramiding" income, often "conjectural" or "inchoate" in nature, into the decedent's estate for *income tax* purposes.[58] Ironically reminiscent of our present problem, the 1934 Act was found objectionable due to the possibility "that [income] taxes, requiring current cash, might often be exacted at death on amounts that might never be collected or where collections would be long deferred."[59] Because of widespread criticism of "bunching" income into one year which might be realized only over a period of many years (exacerbated by steeply progressive wartime tax rates), Congress acted to alleviate the problem with the enactment of I.R.C. § 126.[60] This precursor to the

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5 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 125.7 (2d ed. 1993) (citations omitted) [hereinafter 5 BITTKER]. *Burnet v. Logan* was decided in 1931. A more recent Tax Court opinion reiterates the principle:

> The fact that the legal fees we are concerned with were contingent upon future recovery by the Indian tribes is a critical consideration in trying to determine what the contract right was worth as of the date of death. However, the contingent nature of the contract right must bear on the factual question of valuation. It cannot, as a matter of law, preclude the inclusion of the interest in the decedent's gross estate or command that the value be fixed at zero. Although uncertainty as to the value of a contract right may postpone the inclusion of the income until it is actually realized for *income* tax purposes, for *estate* tax purposes, the value of an asset must be determined in order to close the estate.

Estate of Curry v. Commissioner, 74 T.C. 540, 546-47 (1980), *acq.* 1981-2 C.B. 1 (citations omitted).

56. *See* SEN. REP. NO. 558, 73d Cong., 2d Sess. 28 (1934), 1939-1 (Part 2) C.B. 586, 608. The cash basis taxpayer was taxed on income he earned before his death, and his estate was taxed on income earned by the estate after his death. Income earned by the taxpayer prior to his death but received by his estate after his death was "attributable to no one, and hence, [was] taxable to no one." Gilbert P. Verbit, *Income in Respect of a Decedent*, 56 ST. JOHN'S L. REV. 419, 419-20 (1982).

57. *See* SEN. REP. NO. 1631, 77th Cong., 2d Sess. 100 (1942), 1942-2 C.B. 504, 579-83.

58. *See* John W. Drye, Jr., *The Taxation of a Decedent's Income*, 8 TAX L. REV. 201, 202 (1952-53).

59. *Id.*

60. *See* Verbit, *supra* note 56, at 420-21; SEN. REP. NO. 1631, *supra* note 57, at

present I.R.C. § 691 introduced the concept of income in respect of a decedent, which was specifically aimed at "avoid[ing] the piling up of income in the decedent's final return."[61] The current I.R.C. § 691, enacted in the 1954 Code, is essentially unchanged from the 1942 version.[62] The congressional concern manifested in 1942 for mismatched income and income taxes is, fifty odd years later, seemingly nowhere to be found with respect to estate assets and estate taxes.

Curiously, neither § 126 of the 1942 Code nor § 691 of the 1954 (and current 1993) Code, defines the term "income in respect of a decedent." Professors Bittker and Lokken, after distilling the literature, offer the following:

> Items of income in respect of a decedent . . . are payments received toward satisfaction of a right or expectancy created almost entirely through the efforts or status of the decedent and which, except for his death and without further action on his part, the decedent would have realized as gross income . . . .
>
> First, the item of income must have been taxable to the decedent had he survived to the time the income was realized. This is to say, the income must have been attributable to *his* services, *his* sales, or *his* income-producing property.
>
> Second, although the decedent must have become "entitled" to the income by his death, his rights must not have matured sufficiently to require inclusion of the income in his final income tax return under the accounting method employed by him. This return, normally filed by the executor, is prepared on the decedent's regular method of accounting without reference to any items which might have become accruable solely because of death . . . .
>
> Third, what is transferred at death must be a passive right to receive income, as distinguished from "property" entitled to a [date of death basis under § 1014].
>
> Fourth, the recipient of the right to the income in question must have acquired it solely by reason of the death of the taxpayer who created it. This characteristic subjects income in respect of a decedent to two important limitations,

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580; H.R. REP. No. 2333, 77th Cong., 2d Sess. 83-88 (1942); 4 HOUSE REPORTS 82, 83-88 (1942).

   61. *See* Drye, *supra* note 58, at 203 (citing SEN. REP. No. 1631; H.R. REP. No. 2333).

   62. *See* Verbit, *supra* note 56, at 422.

each of which sheds further light upon the basic concept: First, § 691 presupposes a gratuitous transfer from a decedent at death of a right to income. Second, the ultimate proceeds must be received solely because of the taxpayer's passive status as the decedent's transferee of the specific right.[63]

In analyzing the elements of this extended definition, we are reinforced in our earlier assertion that future lottery payouts constitute IRD. Clearly, the payments are the product of the decedent's activities and would have been taxed as income to him but for his death. Equally clearly, the decedent's rights to the future income are not sufficiently mature (since by statute the payments cannot be accelerated upon his death) so as to warrant their inclusion in the decedent's final income tax return.

The third element, the distinction between a right to receive income and the property which produces that income, is important in some tax contexts but not in ours. If the "income rights" to the future income stream are classified as "property," their value will be the fair market value at the date of the decedent's death[64] and any subsequent disposition of the property will receive the benefit of this stepped up basis. Since the fair market value at the moment of the decedent's death can be determined through discounting to present value or otherwise, and since this figure is greater than the decedent's essentially zero cost basis (one dollar), the step up in basis might be potentially advantageous. But two statutory provisions preclude this potential advantage. First, the step up in basis is specifically denied to IRD.[65] Second, since the beneficiaries cannot dispose of the "property," there is no advantage to our beneficiaries at disposition. Under the Virginia State Lottery Law, the "property" is to be "held in the name of the Department or the Commonwealth and not in the name of the prize winner. Any claim of a prize winner to a future payment remains inchoate until the

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63. 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 83.1.2 (2d ed. 1991) [hereinafter 3 BITTKER] (citing M. CARR FERGUSON ET AL., FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES 146-48 (1970)).
64. *See* I.R.C. § 1014(a)(1) (1993).
65. *See* I.R.C. § 1014(c) (1993).

date the payment is due . . . ."[66] For our purposes then, the basis of the "property" has no significance under current Virginia law, and the distinction between "property" and "income rights" is largely unimportant.

The final definitional element is clearly satisfied: but for the decedent's death, she would have continued to receive the payments; because of her death, the beneficiaries gratuitously receive the payments by standing in the shoes of the decedent as her transferees.

Having fully satisfied ourselves that the future lottery payments are, indeed, IRD, it may be profitable to set aside the question of valuation for the moment, and to examine how other income streams are treated for estate tax purposes. In the following section, seven categories of revenue streams are described and analyzed. The ultimate question of valuation will be revisited later in part V.

II. FEDERAL TAX TREATMENT OF OTHER INCOME STREAMS

A. *Rental Income from Long Term Leases*

Unlike the income rights to future lottery payments whose underlying property is an intangible contract, the rental income from a long term lease is supported by tangible property, itself having a definite value. If a landlord dies holding property leased to another for ninety-nine years, his estate will consist of a term of years (or tenancy for years)[67] and a remainder. The landlord's death does not normally terminate the lease and the property passes to his heirs subject to the leasehold.[68] For our purposes, the question becomes one of distinguishing the value of the underlying property from the value of the stream of rental payments which comprise the term of years.[69]

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66. VA. CODE ANN. § 58.1-4013(B) (Repl. Vol. 1991 & Cum. Supp. 1993).

67. *See* ROGER A. CUNNINGHAM ET AL., THE LAW OF PROPERTY §§ 2.17, 6.14 (1984).

68. *Id.* § 6.83.

69. Although tangible property (especially real property) is usually thought of as having some intrinsic worth or value, it is difficult, for valuation purposes, to fully separate the intrinsic worth from the income producing value dictated by the marketplace. Consider, for example, two office buildings of identical size and design, built

Standard actuarial methods can be employed to divide the value of an estate between the present possessory interest (here the term of years) and the future interest (here the remainder).[70] However, to arrive at the total value for estate tax purposes, this is not strictly required. Essentially, the underlying property which is the subject of the lease must be valued, and that value must then be included in the gross estate.[71] Then the income from the term of years must be separated between the time periods before and after the decedent's death, with the former constituting IRD and the latter constituting ordinary income to the estate. If the leasehold property is an office building, for example, the value of the land and the building must be determined and this value may be apportioned between the present and future interests. "[T]hese interests are valued by determining the fair market value of the underlying property and dividing this value among the several interests in the property."[72] Since the property is subject to a long term lease, the rents accruing over the term would serve as the foundation for valuation purposes with some salvage value of the building and land value ascribed in addition. Once this is done (with the rents reduced to present value), the actuarial tables prescribed in the regulations may be used to apportion the value,[73] but

contemporaneously and adjacent to each other. Their intrinsic worths would be the same. But if one were quickly leased to a quality tenant for a long term lease with terms favorable to the owner, while the other sat vacant, the "values" of the two buildings would soon diverge. If the rental market then turned down due to a recession or overcapacity, the "values" of the buildings would be decidedly different, at least in market, or rent producing terms. Conversely, if the first building were leased at "normal" terms and the market then improved due to lack of capacity, the second building might command a long term lease at terms better than the first. Thus, it can be said that property values are a function of both intrinsic worth and market conditions at any given moment.

70. *See* BORIS I. BITTKER & ELIAS CLARK, FEDERAL ESTATE AND GIFT TAXATION 568 (6th ed. 1990) [hereinafter BITTKER & CLARK]; Treas. Reg. § 20.2031-7 (1984).

71. *See* I.R.C. § 2033 (1993). *See also* United States v. Land, 303 F.2d 170, 172 (5th Cir. 1962) (holding that the estate tax "is an excise tax on the transfer of property at death and not a tax on the property transferred;" further holding that the moment-of-death value controls for estate tax purposes), *cert. denied* 371 U.S. 862 (1962).

72. *See* 5 BITTKER, *supra* note 55, ¶ 135.4.10. *See also* Hanley v. United States, 63 F. Supp. 73, 80 (Ct. Cl. 1945) (holding that the value of a life estate is determined by the annual income, the length of time it is expected to continue and the annual return on investment).

73. *See* Treas. Reg. § 20.2031-7 (1984), *supra* note 4, with additional explanation in that note.

again, for estate tax purposes, this is not strictly necessary.

What then must be apportioned is the income stream generated by the property, this time between the periods before and after the decedent's death:

> Where the decedent dies during a rent period, only the net proceeds attributable to the portion of the rent period ending with his death are income in respect of a decedent. The proceeds attributable to the portion of the rent period which runs from the day after death to the end of the rent period are ordinary income to the estate.[74]

Thus, the "property" may be seen as being composed of two parts. The term of years and the remainder are collectively included in the decedent's gross estate along with the rental income characterized as IRD, the rents earned prior to the decedent's death but collected afterwards. The term of years and the remainder will be subject to the estate tax only and will be eligible for the I.R.C. § 1014 step up in basis; while the IRD portion will be subject to both the estate tax and income taxes, with a deduction for the estate tax paid when computing the income tax liability. The rent attributable to the periods after the decedent's death is considered income of the estate or of the beneficiaries, depending on whether it is earned before or after the closing of the estate, and is subject to income tax only.[75]

The estate must be closed within a reasonable time.[76] The rents actually received attributable to the period after the decedent's death and prior to the closing of the estate must be used to compute the income taxes owed on the estate's final income tax return. The rents for subsequent periods will, of course, be taxable to the beneficiaries as income to them.[77]

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74. Rev. Rul. 64-289, 1964-2 C.B. 173.

75. *See* I.R.C. § 1014(a)(1) (1993); *see also* National Bank of Commerce v. Mathis, 61-2 U.S.T.C. 9,744 (E.D.Ark. 1961) (holding that rent on farm land earned but not collected for period before decedent's death was IRD); Waldrop v. United States, 137 F. Supp. 753 (Ct. Cl. 1956) (holding that income earned by the estate during administration is not part of the gross estate for estate tax purposes and is not taxable as such, but is taxable to the estate as income).

76. *See supra* note 55 and accompanying text.

77. *See* I.R.C. § 61(a)(5) (1993).

B. *Distributions from Qualified Retirement Plans*

Benefits available to employees and their beneficiaries are widely available through a variety of pension plans. These plans are intricately regulated by Code §§ 401 through 418E. Under § 401, employees are not taxed on these benefits when they are initially set aside, but are taxed on them as income under § 402 when the benefits are distributed. Employers receive deductions under § 404 in the year the employer contributions are set aside.[78]

Estate taxation of these benefits is authorized under § 2039, Annuities, enacted in 1954.[79] As originally enacted, § 2039(c) exempted these benefits from estate taxation, causing qualified pension and profit sharing plans to be known as "the quintessential tax shelter."[80] The unlimited exemption was, however, trimmed back in 1982 and § 2039(c) was repealed altogether in 1984 for persons dying after that year. "It was reasoned that the unlimited marital deduction protects qualified plan benefits payable to the surviving spouse from taxation and that benefits payable to others should be subject to tax when the estate exceeds the unified credit."[81] The subject of the marital deduction and its potential role in sheltering lottery payments to an estate or directly to beneficiaries is addressed in part VII(A) of this article.

Section 2039 now consists only of subsections (a) and (b). These two subsections define the parameters for including employee retirement benefits in the employee's gross estate. First, the benefits must be in the form of "an annuity or other payment receivable by any beneficiary by reason of surviving the decedent . . . ."[82] "The payment may be conditional or unconditional, and may include one or more payments extending over any period of time.[83]

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78. *See* I.R.C. §§ 401-418E (1993).
79. *See* BITTKER & CLARK, *supra* note 70, at 327 (discussing § 2039).
80. *Id.* at 328.
81. *Id.*
82. I.R.C. § 2039(a) (1993). *See generally* Estate of Schelberg v. Commissioner, 612 F.2d 25 (2d Cir. 1979) (holding that § 2039 only reaches annuities payable, actually or potentially, to the decedent and the survivor and that payments to the survivor alone are not brought into the gross estate under § 2039).
83. Charles L. Feldman, *Estate Planning for Employee Retirement and Death*

Second, the payments must be receivable "under any form of contract or agreement . . . ."[84] If the employer was contractually bound to make the payments, these amounts are covered by § 2039.[85] Even if the plan was not the subject of bargaining between the employer and employee, a contract may be inferred.

> While one can argue that a plan voluntarily and unilaterally adopted by an employer is not a contract within the meaning of Section 2039, the Service and the courts have generally concluded that such a plan is adopted by reason of the employment relationship and thus the plan constitutes a contract.[86]

Third, the annuity or other payment must have been "payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another . . . ."[87] The annuity or payment must have been the product of a private plan. Government funded plans such as social security[88] or the Railroad Retirement Act[89] are not included in the decedent's gross estate under § 2039. This is because their funding results from a statute, rather than a contract, and because the source of their funding is taxes that have already been paid by either the employee or the company.[90]

Finally, these rules apply only to "such part of the value of the annuity or other payment . . . as is proportionate to that part of the purchase price therefor contributed by the decedent . . . [or his] employer or former employer . . . ."[91] Contri-

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Benefits, 171 PLI/EST. 173, PLI Order No. D4-5191 (1986) (citing Treas. Reg. § 20.2039-1(b) (1976)).

84. I.R.C. § 2039(a) (1993).

85. *See* Estate of Bahen v. United States, 305 F.2d 827 (1962) (company plan deemed irrevocable).

86. Feldman, *supra* note 83, § V.D.1.(ii).

87. I.R.C. § 2039(a) (1993).

88. *See* Rev. Rul. 81-182, 1981-2 C.B. 179.

89. *See* Rev. Rul. 60-70, 1960-1 C.B. 372, *modified by* Rev. Rul. 73-316, 1973-2 C.B. 318.

90. *See* BITTKER & CLARK, *supra* note 70, at 338-39.

91. I.R.C. § 2039(b) (1993).

butions by the employer because of the employment relationship are imputed to the employee.[92]

The value of the "annuity or other payment" for estate tax purposes is calculated based on the present value of the future stream of payments, based on the life expectancy of the beneficiary.[93] As noted, the unlimited marital deduction will shield the surviving spouse from the estate tax, but non-spousal beneficiaries will be subject to the tax within nine months of the decedent's death.[94]

When the annuity payments are actually received by a beneficiary, they constitute income in respect of a decedent.[95] As such the estate tax previously paid may be deducted in computing the survivor's income tax liability.[96]

C. *Royalty Income from Patents and Copyrights*

Like rental income from long term leases, discussed in part II(A), it is necessary in the case of intellectual property to distinguish between the income stream, or royalties, flowing from the property and the underlying property itself. In the case of intellectual property, however, the underlying property, unlike a parcel of land or a building, seldom has any tangible worth in its own right. The plans and specifications for an invention, for example, or the manuscript for a book, could be worth no more than a few dollars insofar as paper and ink are concerned. Still, this underlying property, to the extent it is protected by national and, increasingly, international intellectual property covenants,[97] is often quite valuable, and its intrinsic worth may be great despite its absence of tangible value.

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92. *See* Treas. Reg. § 20.2039-1(c) (1976).
93. *See* Treas. Reg. § 20.2031-7 (1984).
94. *See* I.R.C. § 6075(a) (1993).
95. *See* Miller v. United States, 389 F.2d 656 (5th Cir. 1968) (monthly payments by employer to decedent's widow were income in respect of a decedent); Feldman, *supra* note 83, § V.F. & n.184 (citing Rev. Rul. 73-327, 1973-2 C.B. 214 (survivor benefit payments pursuant to decedent's employment contract are income in respect of a decedent and are included in survivor's gross income).
96. *See* I.R.C. § 691(c) (1993).
97. *See generally* WORLD INTELLECTUAL PROPERTY ORGANIZATION, BACKGROUND READING MATERIAL ON INTELLECTUAL PROPERTY (1988).

The intrinsic worth or property value of intellectual property is, of course, a function of the anticipated royalties which will flow from the publication of the work or the manufacture and sale of the product. The valuation techniques employed are often esoteric and industry-specific. For example, the motion picture industry, through long experience, has developed a formula by which projected royalties can be estimated.[98] When contested by the Service, the parties almost invariably resort to expert witnesses.[99] At least as far back as 1939, the courts have used the discounted present value of the future royalties in establishing their value for estate tax purposes.[100] In a more recent (gift tax) case, the court's opinion set forth the expert's methodology in detail.[101]

The now-familiar IRD treatment is widely applicable to interests in patent and copyright royalties.[102] However, the precise nature of the decedent's interest must be ascertained. If the inventor-decedent or author-decedent had sold his patent or copyright to a manufacturer or publisher, and his proceeds were to be paid in installments, his interest would have matured to the point that post mortem installments would be considered IRD. On the other hand, if the decedent had merely licensed

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98. *See* Dorsey v. Commissioner, 49 T.C. 606, 630 (1968) (citing with approval the methodology used by an "established industry"); Rev. Rul. 65-192, 1965-2 C.B. 259 (holding that the formula approach may be used to value intangibles absent a better approach), *superseded by* Rev. Rul. 68-609, 1968-2 C.B. 327 (defining the "formula" approach and expanding on the earlier ruling).

99. *See* Estate of Pascal v. Commissioner, 22 T.C.M.(CCH) 1766 (1963) (opinion of petitioner's expert discounted as having no "real basis").

100. *See* Estate of Pedro Pacheco Martinez, 1939 B.T.A.M. (P-H) ¶ 39,223 (fair market value of royalties calculated on basis of present worth for estate tax purposes).

101. *See* Smith v. Commissioner, 41 T.C.M.(CCH) 1427 (1981). The Service's expert calculated the value of the disputed patents as follows:

> His approach largely paralleled that of petitioner's expert, multiplying (a) the potential market (50,000 units) by (b) anticipated market penetration (3 percent), by (c) unit cost ($1,000), by (d) a reasonable royalty rate (1 percent), and then discounting the result for the present value of money (.6). In addition, he considered patent validity (75 percent) and technological feasibility (50 percent). Multiplying all of these figures together [the expert] determined the fair market value of the U.S. patents at $3,375—which he rounded to $3,500.

Id. at 1428.

102. *See* Alan D. Seget, *Estate Planning for Intellectual and Creative Property, in* ESTATE PLANNING FOR THE UNUSUAL ASSET, 153 PLI/EST. 123, 133, PLI Order No. D4-5170 (1984).

the intellectual property to a manufacturer or publisher, the decedent's interest would be analogous to the landlord holding a long term lease; payments attributable to the periods after the decedent's death would be classified as ordinary income to either the estate or the beneficiaries.

> Problems can arise in characterizing receipts as "rent" or "royalty" income, on the one hand, or "sale proceeds" or "joint venture" income, on the other. The difference is significant in many contexts, including Section 691. Thus, the IRS has ruled that where an arrangement between an author and a publisher, or between an inventor and a user, constitutes a "sale" of a manuscript or invention made prior to death, all receipts will constitute IRD. On the other hand, where the arrangement is regarded as a license, receipts attributable to post-death sales or profits will be ordinary income, and in most cases the underlying property interest passing to the author's or inventor's successors will receive a stepped-up, amortizable basis under Sections 1014 [Basis of Property Acquired from a Decedent] and 167 [Depreciation].[103]

D. *Income from Oil and Gas Interests*

The unique nature of oil and gas (and hard mineral) properties and their concomitant unique tax treatment make them possibly the least apposite candidates for purposes of compari-

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103. NORMAN H. LANE & HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS ¶ 15.05[3][e] (1988) (citing Rev. Rul. 57-544, 1957-2 C.B. 361 (1957), *distinguished by* Rev. Rul. 60-227, 1960-1 C.B. 262 (1960)). The earlier ruling was ambiguously worded, using terms such as "contract" and "transferred to the publishers the sole right to publish" instead of the unambiguous "sale" or "license." Rev. Rul. 57-544. The later ruling "clarified" the earlier:

> In summary, it is concluded that if a contract entered into between an inventor and a manufacturer constitutes merely a "license" to use the inventor's patent in return for the payment of royalties, and not a "sale," royalty payments due and accrued under the contract at the date of death of the inventor constitute income in respect of a decedent under section 691(a) of the Code. Where the contract constitutes a "license," royalty payments accrued after the date of death of the inventor are ordinary income includible in the gross income of the recipient under section 61 of the Code.

Rev. Rul. 60-227.

son with lottery payouts. Nonetheless, some analogies can be drawn, and thus a brief discussion is appropriate.

The defining characteristic of mineral properties is the wasting of assets. The store of mineral wealth is finite and once depleted, the asset is worthless. Land is not depreciable because its life is considered infinite. Buildings are depreciable, but may be repaired and refurbished to extend their useful lives more or less indefinitely. But with oil and gas, "[t]he quantity of hydrocarbons within a formation is finite. When it is depleted, the value of the underlying asset is exhausted and consequently, so is the value of any mineral rights, royalties, or other interests."[104]

The second unique characteristic of mineral properties is that ownership of the mineral estate (extraction rights) may be legally severed from surface ownership. In the case of oil and gas, the mineral estate may be subdivided into drilling and production rights and the rights to income therefrom. Typically, the landowner or owner of the mineral estate signs a lease with a driller under which the landowner receives a fixed fraction of all production as royalties, with the driller or lessee retaining the balance as his "working" or "operating" interest.[105] For purposes of comparison with lottery payouts, we are most interested in the landowner's royalties, but to arrive at a value for this component interest, we must first reach a valuation for the property as a whole.

The valuation of oil and gas properties, like the valuation of patents and copyrights, is the subject of frequently conflicting expert opinion. Nonetheless, several criteria have been developed and have received wide recognition by the Service and the courts:

> 1. An actual sale of the property or a fractional   interest therein.
> 2. Actual sales of comparable properties.
> 3. Valuations for purposes other than Federal taxation.
> 4. Engineer's appraisals, i.e., analytical appraisals.
> 5. Bona fide offers to sell or purchase the property.

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104. James W. Buchanan, III, *Valuation and Taxation of Transfers of Oil and Gas Interests to Charities*, 22 REAL PROP. PROB. & TR. J. 561, 564 (1987).
105. *Id.* at 562.

6. Opinions of people who buy and sell similar oil and gas properties.

7. Opinions of operators of oil and gas properties.[106]

The Service relies on these factors in various combinations, but generally prefers the factors that draw on actual market experience, as opposed to seemingly precise analytical appraisals.[107] The Regulations support this preference, proscribing valuation by analytical appraisals if "value . . . can be determined upon the basis of cost or comparative values . . . or [i]f the fair market value can reasonably be determined by any other method."[108]

The Regulations go on to provide the criteria to be analyzed when using the alternative, engineering-based approach.[109] In using this alternative approach to valuing oil and gas properties, the Regulations specify that the present value of the future extractions shall be calculated. In this respect, there is a close analogy between the valuation of oil and gas properties and the valuation of a future stream of lottery payments as manifested in current IRS policy.[110] However, the Regulations mandate the determination of fair market value as the basis of any valuation[111] and elsewhere define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[112]

There is thus an inconsistency between the Service's approach to the valuation of a stream of lottery payments as opposed to its preference in valuing oil and gas properties. With respect to oil and gas properties, the Service clearly prefers

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106. Donald G. Williamson, *Federal Estate and Gift Taxation of Oil and Gas Properties*, 19 BAYLOR L. REV. 173, 180 (1967) (citing Leland E. Fiske, *Valuation and Oil Properties*, 13 OKLA. L. REV. 267 (1960)).

107. *See* Buchanan, *supra* note 104, at 566.

108. Treas. Reg. § 1.611-2(d)(2) (1972).

109. *See* Treas. Reg. § 1.611-2(e) (1972).

110. *See supra* note 1 and accompanying text.

111. *See* Treas. Reg. § 1.611-2(d) (1972).

112. Treas. Reg. § 20.2031-1(b) (1965).

valuation based on fair market value as determined by actual sales of comparable properties and other market-related indicia. There is no need to consider present value; find a "comparable" and use it as a benchmark to extrapolate a value for the property being assessed. The analytical appraisal, with its reliance on projecting future extractions and then reducing these to their present value, is clearly a less preferred method of valuation as far as the Service is concerned. However, in its stated policy towards future lottery payouts, the IRS mandates the calculation of a present value from the future revenue stream. In so doing, the Service eschews any approach more closely tied to actual market conditions which are measured by the price arrived at by the willing buyer-willing seller approach. The IRS policy could possibly be defended since, under Virginia law, there is no willing buyer (alienation or assignment being prohibited) and thus no real marketplace. But there is a theoretical market and a theoretical price at which a buyer could be found to unburden the winner's estate of its problem. This theoretical solution (consistent with the Service's professed desire to mimic market conditions) will be addressed in depth in part V.

To conclude our discussion of oil and gas properties, it need only be noted that the value of the property on the date of the decedent's death (or the alternate valuation date) must be used in computing the estate tax. If the owner is also the driller, the full value is included in the owner-decedent's gross estate. If the owner has leased the mineral rights to a driller and has retained rights to only a fixed fraction of the future extractions as royalties, the owner-decedent's fractional share of the total value is the amount included in his gross estate.

E. *Income from Financial Instruments, e.g. Bonds*

In general, the value assigned to stocks or bonds held by the decedent is the fair market value on the date of death (or the alternate valuation date). This value, in the case of publicly traded securities, is normally the mean of the highest and low-

est quoted selling prices for the date of valuation or, if necessary, the mean of the bid and asked prices.[113]

If the decedent dies holding a bond and attached coupons evidencing a right to future income, the valuation for estate tax purposes would be the principal amount of the bond as well as the amount of the coupons discounted to their respective maturities.[114] This is entirely consistent with the general principle that "whenever a person dies owning a right to future income the value of this right is taxable to his estate under the estate tax."[115]

If the decedent died holding federal redeemable bonds, or "flower bonds," these bonds may be submitted at par value to pay federal estate taxes.[116] Because of this, they are included in the decedent's gross estate at par value (as opposed to market value) and are taxed accordingly.[117]

One of the most common assets found in estates of all sizes is the U.S. Series "EE," or the older Series "E," savings bond. Other than their discounted sale prices (fifty percent and seventy-five percent of face value, respectively), they are equivalent and are subject to equal tax treatment.[118] Unlike coupon bonds, U.S. savings bonds do not pay interest to the bondholder on a periodic basis. Rather, the bonds accrue interest, building toward face value. Accrual basis taxpayers must compute the accrued interest annually and report it as income, while cash basis taxpayers may defer federal income tax until redemption (savings bonds are exempt from state income tax).[119]

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113. *See* Treas. Reg. § 20.2031-2 (1992).

114. *See* CHARLES L. LOWNDES & ROBERT KRAMER, FEDERAL ESTATE AND GIFT TAXES 47 (2d ed. 1962).

115. *Id.*

116. *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.02[3][e] (6th ed. 1991).

117. *See* BITTKER & CLARK, *supra* note 70, at 579 (citing Bankers Trust Co. v. United States, 284 F.2d 537 (2d Cir. 1960), *cert. denied*, 366 U.S. 903 (1961)); Rev. Rul. 69-489, 1969-2 C.B. 172.

118. *See* Michael E. O'Connor, *U.S. Savings Bonds in the Estate*, 64 N.Y. ST. B.J. 39, 39 (1992).

119. *Id.* at 39 (citing 31 C.F.R. § 353.30 (1979); 31 C.F.R. § 351.8(a) (1990)).

The interest accrued, but not realized, at the death of the decedent is considered income earned by him and is treated as income in respect of a decedent, subject to both the estate tax and income tax. The date of death redemption value of the bonds (with interest computed to that date) is included in the gross estate. Interest accrued after that date is considered ordinary income, reportable on the estate's income tax return.[120] Since the bonds are invariably redeemed before closing the estate, there is no stream of future income to discount for estate tax purposes. A beneficiary named on the bond may, however, continue to defer taxation. If the bonds are owned by the decedent alone, they may not be reissued after his death to a beneficiary of the estate without first recognizing the income and paying the tax. But if a beneficiary is named on the bond, that beneficiary may continue to hold the bond without recognizing the gain. The gain will be recognized only when the named beneficiary redeems the bond. The bonds are not permitted a section 1014 step up in basis when the named beneficiary redeems them.[121]

F. *Distribution of Interest in Partnerships or S-Corporations*

The estate and income tax treatment of installment distributions of a decedent's interest in a partnership or subchapter-S corporation is complex and can receive only the most cursory examination here. The starting point in any analysis is to determine the value of the partnership or corporation. For valuation purposes, we will examine the criteria applicable to closely held corporations and extend those criteria to partnerships.[122] The Service, in a widely quoted ruling, has listed eight factors to be considered: .

> (a) The nature of the business and the history of the enterprise from its inception.
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.

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120. *Id.* at 40 (citing I.R.C. § 691(c)(1) (1992)).

121. *Id.* at 41.

122. *See* STEPHENS, *supra* note 116, ¶ 4.02[3][f] & nn.66-67 (citations omitted)(observing that shares of closely held corporations, for estate tax purposes, are those shares not normally traded and for which no value is readily available, and that unincorporated business interests are valued in the same manner).

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar business, whose stocks are actively traded in a free and open market, either on an exchange or over-the-counter.[123]

Despite the repeated references to "stock," the Regulations and a ruling make it clear that the applicable criteria should be used in valuing unincorporated businesses as well as closely held corporations.[124] "[T]here is no regular market to turn to, and the value of the assets must be considered in the light of other factors. The Regulations place a special emphasis on goodwill in such situations, as it is often a major intangible asset in unincorporated businesses."[125]

Once the partnership or corporation has been valued, the proportionate share owned by the decedent is the amount to be included in the gross estate. Frequently this amount cannot be taken out of the business in the year of death, due to the illiquidity of the partnership or corporation, and the other assets of the estate may not be sufficient to pay the estate tax. If the decedent's share of the value of the closely held business exceeds thirty-five percent of his adjusted gross estate, and his interest in the business is at least twenty percent of the business' total capitalization, the estate is eligible to pay the estate tax in installments. Even though interest is payable on the unpaid amounts, the interest paid is deductible as an

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123. Rev. Rul. 59-60, 1959-1 C.B. 237, *modified by*, Rev. Rul. 65-193, 1965-2 C.B. 370, *and amplified by* Rev. Rul. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-123, 1980-2 C.B. 101, Rev. Rul. 83-120, 1983-2 C.B. 170. The ruling is a lengthy one and addresses the weight to be accorded the various factors, the effect of restrictive agreements on the value to be assigned, the relationships of the parties and the relative number of shares held by the decedent. *Id.* at 242-44.

124. *See* STEPHENS, *supra* note 116, ¶ 4.02[3][f]; Treas. Reg. § 20.2031-3 (1992); Rev. Rul 68-609, 1968-2 C.B. 327 (1968).

125. *Id.*

administrative expense of the estate, and the estate tax may be spread over a period of fourteen years from the date the tax otherwise would be due.[126]

For purposes of comparison with a revenue stream of lottery payments, we must next examine how distributions of partnership or close corporation interests over time are taxed.

Partners and partnerships are taxed under subchapter-K of the Code. As a general principle, a partnership interest is considered property, as opposed to IRD, and the property acquires a stepped up basis at the decedent's death.[127] The property is assigned a date of death value and is subject to the estate tax only. There are, however, three exceptions to the general rule, and for many estates of partner-decedents, the exceptions may be more important than the rule. First, if the decedent's estate receives the former partner's unrealized receivables as a distributive share of the partnership's income, or as a guaranteed payment, pursuant to I.R.C. § 736(a), the receivables are considered IRD under §§ 753 and 691, and their present value is included in the gross estate.[128] Second, the decedent's fractional share of partnership income attributable to the period before the deceased partner's death is considered IRD.[129] Finally, the decedent's interest in certain "partnership level" unrealized receivables is also considered IRD.[130] In all three instances, the decedent's right to any periodic payments is reduced to present value and subjected to the estate tax and, subsequently, to income tax.

Distributions from S-corporations to a decedent-shareholder's estate are treated quite differently from partnership distributions. When a shareholder dies, the shareholder's portion of the

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126. *See generally* Richard Z. Kabaker, *Deferral of Estate Tax under Section 6166*, C756 ALI-ABA 517 (1992); David W. Reinecke, *Post-Mortem Tax and Estate Planning*, 9 T.M. COOLEY L. REV. 383 (1992); Martin R. Goodman, *Tax Elections for Closely Held Businesses: IRC Sections 303, 6166 and 2032A*, 201 PLI/EST. 155, PLI Order No. D4-5220 (1991).

127. *See* LANE & ZARITSKY, *supra* note 103, ¶ 15.06[1][a] (citing I.R.C. §§ 742, 1014 (1992)).

128. *Id.* ¶ 15.06[1][b].

129. *Id.* ¶ 15.06[1][c] (citing Treas. Reg. § 1.706-1(c)(3)(v) (1987)).

130. *Id.* ¶ 15.06[1][d] (citing Quick Trust v. Commissioner, 54 T.C. 1336, *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); Woodhall v. Commissioner, 28 T.C.M. (CCH) 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972); Rev. Rul. 66-325, 1966-2 C.B. 249).

corporation's profits for the year is normally prorated according to time: if the date of death occurs halfway through the corporation's taxable year, for example, half of the decedent's share of the corporation's profits is reported on his individual return as ordinary income, and half is reported on the estate's return as ordinary income.[131] With the concurrence of all shareholders including the decedent's estate, the decedent's share can be calculated by an interim closing of the books.[132] "Given this pattern, neither any corporate profits nor any distributions should ever constitute IRD."[133] As a further demonstration of the favorable treatment accorded decedent-shareholders of S-corporations,

> [d]istributions to the estate will generally be tax free unless the corporation had accumulated earnings and profits in years when it was not an S corporation. In this case, distributions may be taxed as dividends to the extent of such accumulated earnings and profits, once all post-S earnings are distributed.[134]

G. *Income from Installment Sales*

The treatment of proceeds from the sale of property pursuant to I.R.C. § 453, Installment Method, is fairly straightforward. When the obligee of the transaction dies before collecting all the installments, the remaining installments are payable to the obligee's estate. As a general rule, post mortem proceeds in the form of installment sale payments are considered IRD to the extent of gain on the sale. Installment payments representing basis not yet recovered are not IRD and are not taxable.[135] The interaction of sections 453 and 691 occasionally produces complexities, but the law in this part of the Code is relatively well settled.[136]

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131. *Id.* ¶ 15.06[2] (citing I.R.C. §§ 1366(a), 1377(a)(1) (1992)).

132. *Id.* (citing I.R.C. § 1377(a)(2) (1992)).

133. *Id.*

134. *Id.* (citing I.R.C. § 1368(c) (1992)).

135. *Id.* ¶ 15.07[1] (citing I.R.C. § 691(a)(4) (1992)).

136. This was not always true. For a good historical sketch of the statutory and case law, as well as a discussion of the legal and economic theories that supported the law's development, see Note, *Sales Transactions and Income in Respect of a De-*

In almost all cases, the transaction will involve the sale of property.[137] Because property in the hands of the obligee will have a basis (even if the basis is zero), the installment proceeds must be segregated to reflect recoupment of basis as well as gain on the transaction. Post-mortem proceeds flowing to the decedent's estate retain the same character they would have had if they had flowed directly to the obligee.[138] Thus, if the sale represented a capital transaction, the gain to the obligee would have been a capital gain and the IRD (after recoupment of basis) would represent capital gains insofar as income taxation of the IRD is concerned. The estate tax would apply simply to the present value of the future installments, irrespective of the capital or ordinary gain character of the proceeds.

Special rules prevent the estate (or the beneficiaries) from selling or assigning the rights to installment payments in order to escape taxes. For example:

> If the estate or legatee sells, transfers to a nonqualified successor, or collects the installment obligation at other than its face amount, IRD income is realized to the extent of the greater of (1) the amount realized on the disposition or (2) the fair market value of the obligation, over the decedent's basis in the obligation.[139]

The Installment Sales Revision Act of 1980[140] added § 691(a)(5) which prevents avoidance of the tax by the expedient of the obligee bequeathing the note to the obligor:

> Since 1980, the Code has included a specific rule to deal with cases where the decedent bequeaths an installment obligation held by him or her before death to the obligor of the payment. When this occurs, any previously unrealized gain inherent in the receivable at the time the decedent

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cedent, 3 GA. L. REV. 606, 607 (1969).

137. Contracts for the installment payment of personal services, such as a large legal or medical bill payable over a number of years, are not included. Such bills would normally be reflected in the receivables of the obligee and, in the event of the obligee's death would be subject to the treatment described in part II (F).

138. *See* I.R.C. § 691(a)(3) (1993).

139. LANE & ZARITSKY, *supra* note 103, ¶ 15.07[2] (citing I.R.C. §§ 691(a)(2), 691(a)(4)(B) (1992)).

140. Act of Oct. 19, 1980, Pub. L. No. 96-471, § 3, 96th Cong., 2d Sess. (1980).

died is taxed to the decedent's estate, and is reported on the first fiduciary income tax return filed by the estate. Under earlier case law, it could be argued that the gain was effectively forgiven and eliminated through this device.[141]

The 1980 Act also tightened the rules in cases where the obligor and the obligee are related:

> The current rule (Section 691(a)(5)) also provides that, in determining the amount of any income in respect of a decedent, the fair market value of the obligation cannot be less than its face amount, if the obligor and obligee are related parties. This ensures that the full amount of gain that the decedent would have recognized had the decedent survived to collect the receivable will be taxed to the estate. If the fair market value of the receivable exceeds its face amount, because the contract interest rate exceeds market interest rates, it appears that the estate is also subject to tax on the excess.[142]

H. *Tentative Conclusions with Respect to Comparability*

After reviewing the revenue streams described in part II, subsections (A) through (G), some general conclusions seem justified. For estate tax purposes, the future revenue stream is simply reduced to present value in the case of pension plan annuities, patent and copyright royalties, coupon bonds, partnership receivables and payments on installment sales. The rent on a long term lease is not per se reduced to present value and taxed directly, but the effect is virtually the same when the long term rents serve as the primary determinant of the underlying property's current fair market value. Oil and gas properties may be valued according to engineering (analytical) appraisals which project future extractions and discount them to present value, but the Service prefers a market based approach which relies on the recent sale of comparable properties.

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141. LANE & ZARITSKY, *supra* note 103, ¶ 15.07[3][a] (citing I.R.C. § 691(a)(5) (1992); Miller v. Usry, 160 F. Supp. 368 (W.D. La. 1958)).

142. *Id.* ¶ 15.07[3][b] (citing I.R.C. § 691(a)(5)(B) (1992)). For definitions of related parties, *see* I.R.C. §§ 318(a), 453(f) (1992).

Future interest payments on U.S. savings bonds are not a consideration since these bonds are taxed on their date of death redemption value with accrued interest included. Distributions from S-corporations are normally made as ordinary income, and no IRD or present value calculation is necessary.

Thus, a recurrent, although not universally applied, theme in the examples of future revenue streams is the concept of discounting the future revenues to their present value, and then subjecting that value to the federal and state estate taxes. The situation most directly analogous to future lottery payouts is that of an installment sale, wherein the obligee contracts with the obligor to receive his consideration in installments. When the obligee or lottery winner dies before all installments are collected, the remaining installments are reduced to present value and the estate tax is computed.

The one constant present in all these examples which is *not present* in the case of future lottery payouts, is the liquidity or marketability of the underlying asset. If estate taxes in any of these seven examples exceed the ability of the estate to pay from other assets, the asset giving rise to the tax liability may itself be sold or assigned in order to raise the cash to pay the estate tax. This is, at least under current Virginia law, not true for future lottery payouts flowing to a decedent's estate.[143] Given the general consistency of the federal estate tax statutes and regulatory interpretations which reduce future revenue streams to their present value, it appears that the Service is justified in prescribing this treatment for future lottery payouts. But given that marketability of the underlying asset is seemingly *assumed* by the Service, the fact that lottery payouts lack this quality indicates that some concession on the part of the Service is in order. This concession probably should come in the form of relaxation of the rigid application of the annuity tables prescribed in the Regulations.[144] The possibility of revisiting the issue of valuation, alluded to at the end of part I(F) is the most equitable avenue for addressing the dilemma of the

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143. *See* VA. CODE ANN. § 58.1-4013. (Repl. Vol. 1991 & Cum. Supp. 1993). The beneficiaries of a deceased lottery winner do have the option of disclaiming the bequest, thereby avoiding the liquidity and tax problems altogether. For the initially euphoric beneficiaries, this will be of little consolation.

144. *See supra* notes 4, 24 and accompanying text.

deceased lottery winner. Such an approach would preserve the integrity and consistency of the IRD and present value concepts, while still acknowledging the inherent unfairness of applying the estate tax to an asset which cannot be liquidated to pay the tax. We will return to a discussion of valuation in part V.

III. STATE DEATH AND INCOME TAX IMPLICATIONS

In Part I(D), we addressed the impact of state death (estate) taxes on the overall tax problem. We noted that the Virginia Estate Tax Act is keyed to the federal tax Code, with the Virginia estate tax imposed in (and thus capped at) "the amount of the federal credit . . ."[145] or, for the Virginia estates of nonresidents, a fraction of the federal credit.[146]

Residents of other states, or Virginia residents holding property in other states, should be aware that other state codes may not be similarly synchronized with the federal Code. If those state codes impose a state death tax exceeding the federal credit specified in I.R.C. § 2011(b), the excess will not be offset by the federal credit and the combined federal/state estate tax will be higher than the federal tax alone. The scenarios depicted in Tables 1 and 2 in part I(D) would be impacted accordingly.

State income tax statutes must also be considered. Those state codes which "piggyback" on the federal Code may offer some relief in the form of a deduction for the federal estate tax paid.

This (federal) deduction may be applied ratably over the years when the lottery payouts (IRD) are actually received[147] when computing the estate's or the beneficiary's federal income tax. Virginia taxpayers' taxable income is their "federal adjusted gross income for the taxable year . . . with the modifications specified . . . ."[148] In computing their state taxable income,

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145. VA. CODE ANN. § 58.1-902(A) (Repl. Vol. 1991).
146. *Id.* § 58.1-903(A).
147. *See* I.R.C. § 691(c)(1)(A)-(B) (1993); *see also supra* note 41 and accompanying text.
148. VA. CODE ANN. § 58.1-322(A) (Repl. Vol. 1991 & Cum. Supp. 1993).

Virginia taxpayers are entitled to deduct.from their federal AGI "[t]he amount allowable for itemized deductions for federal income tax purposes where the taxpayer has elected for the taxable year to itemize deductions on his federal return . . . ."[149] Thus, the deduction for federal estate taxes paid does double duty—first as a deduction in computing federal income taxes, and then as a deduction in computing Virginia income taxes. It should be noted that the deductions are for *federal* estate taxes paid. To the extent that federal estate taxes otherwise due are reduced by the federal credit for state death taxes paid, the deduction for federal income tax purposes is the net federal estate tax paid after subtracting the amount of the credit for state death taxes. Because the Virginia income tax deductions "piggyback" on the federal income tax deductions, the Virginia estate tax paid is similarly not available as a deduction when computing the Virginia income tax.

The income tax statutes in other states may not parallel those of Virginia in this respect, and they should be studied carefully to determine their full impact.

IV. SOLUTIONS AT THE CONGRESSIONAL LEVEL

As noted in part I(C), upon a showing of "undue hardship," the IRS may grant the lottery winner's beneficiaries up to ten years to pay, without penalty, but with interest, the federal estate tax due.[150] Likewise, as noted in part II(F), if certain qualifications are met, the estate tax due on a decedent's interest in a small business may be, paid over a period of fourteen years.[151] Thus, precedent has been set by statute to grant extended periods to pay the federal estate tax in cases of hardship.[152] Since the lottery payments at issue are, by (Virginia) state statute, payable only over a period of twenty years, it seems consistent with the Service's policy to enact a statutory provision allowing payment of estate taxes over the same period in which the lottery payouts giving rise to the taxes are

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149. *Id.* § 58.1-322(D)(1)(a).
150. *See supra* note 21 and accompanying text.
151. *See supra* note 126 and accompanying text.
152. This policy is specifically reinforced by Treas. Reg. § 20.6161-1(a) (1992), example (2). *See supra* note 21.

received. The present value of the future revenue stream could be computed prior to closing the estate. Then the overall estate tax could be calculated and the tax liability not ascribable to lottery winnings could be paid out of the assets of the estate. The portion of the tax liability ascribable to lottery winnings could then be assigned to the individual beneficiaries to be paid over the "life" of the lottery receipts.

Such a provision would do nothing to undermine the IRD or present value concepts embedded in numerous sections of the Code. Further, the fact that interest would be assessed on the unpaid balances would assure the Service that the revenues due and payable would not be eroded by inflation.

V. SOLUTIONS AT THE IRS LEVEL

In parts I(E) and II(H), we discussed the fact that a common characteristic of the other streams of future revenue is their liquidity or marketability. If necessary, they may be liquidated in order to raise the cash to pay the estate tax due. We noted that under Virginia law, this option is not available to the estates or beneficiaries of lottery winners since the winnings are not transferable. In part I(C), we discussed the principle of discounting the value which would otherwise attach for estate tax purposes to reflect this diminished marketability, and in parts I(F) and II(H) we promised to return to the "ultimate" issue of valuation. As noted in part I(C), the present value of future lottery payouts is certainly greater than zero, but because the income rights are not alienable, they do not have the value that would be derived from standard government annuity tables. We must now direct our attention to the task of determining this value.

The Code is virtually silent with respect to the question of valuation. The two estate tax sections of general application, sections 2031 and 2033, use circular language such as "[t]he value of the gross estate . . . shall be determined by . . . the value at the time of . . . death of all property . . . "[153] and "[t]he value of the gross estate shall include the value of all

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153. I.R.C. § 2031(a) (1993).

property to the extent of the interest therein of the decedent at the time of his death."[154] The Code thus provides no real guidance in assigning a dollar amount to the value of lottery payouts. "On difficult questions of valuation, one must ordinarily turn from the Code to the estate and gift tax regulations, and then to the vast, uncoordinated, and sometimes inconsistent body of case law and administrative rulings."[155]

The one refrain which echoes throughout the Regulations is that of fair market value, and unlike the Code, the Regulations do supply a definition:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price.[156]

This willing buyer-willing seller definition of value has been applied by the courts in hundreds of tax cases.[157] The U.S. Supreme Court has approvingly noted it to be "nearly as old as the federal income, estate, and gift taxes themselves."[158]

It is, perhaps, useful to make a distinction between "fair" value, which connotes normal or inherent value, on the one hand, and "fair market" value, on the other. The meaning of the latter disregards any intrinsic value and simply ascribes value according to the price dictated by the free and open working of the market:

> Two conceptions of value are possible. First it is apparent that an asset always has some theoretical, underlying value which is revealed or made apparent by subsequent events.

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154. *Id.* § 2033 (1993).

155. 5 BITTKER, *supra* note 55, ¶ 135.1.1.

156. Treas. Reg. § 20.2031-1(b) (1965) (estate tax). For substantially similar language, see § 25.2512-1 (1992) (gift tax) and § 1.170A-1(c)(2) (1990) (income tax).

157. *See* 5 BITTKER, *supra* note 55, ¶ 135.1.2 n.22 (citing Emanuel L. Gordon, *What Is Fair Market Value?*, 8 TAX L. REV. 35 (1952) (definition applied in over 500 tax cases as of 1952)).

158. 5 BITTKER, *supra* note 55, ¶ 135.1.2 (quoting United States v. Cartwright, 411 U.S. 546, 551 (1973)).

> For example, an unsigned painting by Botticelli languishing in a second hand art shop with a minimal price tag always had the same inherent value which it acquires when the creator of the painting is later discovered. In a second sense, however, value is a practical process, always changing in accord with the price that it will yield on the market at a given time. In this sense, the undiscovered Botticelli has a value far less than its "inherent" value. The Code and the Regulations clearly enshrine this second sense of value.[159]

The twin concepts of fair market value and discounting to reflect illiquidity are both intuitive and mutually reinforcing. If a block of stock is so large that it cannot be sold without depressing all the shares of that stock, a discount for the special underwriter sale required would be necessary both to "move" the stock and to reflect the price that the seller would actually realize. If the shares of a small, family-held business are not traded on an exchange, they would have no nominal fair market value, and a discount from book value might be required to generate the investor interest that is required to set a market value and, coincidentally, to move the offering.[160] In part I(C),[161] cases were cited reflecting discounts of thirty-five and forty-three percent. The amount of the discount may be affected by many factors. "In general, any factor that would reasonably be considered in determining whether property should be purchased or sold is relevant in determining fair market value for estate tax purposes."[162] Indeed, nonmarketability discounts of almost ninety percent have been recorded.[163]

Before addressing directly the question of valuing future lottery payouts, a final general observation is in order. Although courts like to see evidence of the "real" market in opera-

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159. 5 BITTKER, *supra* note 55, ¶ 135.1.2 (quoting American Nat'l Bank & Trust Co. v. United States, 594 F.2d 1141, 1144 n.2 (7th Cir. 1979) (estate tax)).

160. *See supra* notes 17-20 and accompanying text.

161. *See supra* note 18.

162. STEPHENS, *supra* note 116, ¶ 4.02[2] (citing Estate of Smith v. Commissioner, 57 T.C. 650, 658 n.7 (1972), *aff'd on other grounds*, 510 F.2d 479 (2d Cir. 1975), *cert. denied*, Lowe v. Commissioner, 423 U.S. 827 (1975)).

163. *See* George S. Arneson, *Nonmarketability Discounts Should Exceed Fifty Percent*, 59 TAXES 25, 25 (1981)(citing Robert E. Moroney, *Most Courts Overvalue Closely Held Stock*, 51 TAXES 144, 144-56 (1973)).

tion, as evidenced by sales of comparable property, the litera-
ture contains numerous references to theoretical transactions
involving hypothetical willing buyers and sellers.[164] It is to
such a transaction that we now turn.

We saw in Table 2 in part I(D) that the net lottery proceeds
over the twenty year period 1992-2011 aggregated to
$7,984,541. We also saw, without a great deal of discussion,
that the future value of these net proceeds, assuming reinvest-
ment of the net proceeds at an after-tax return of six percent,
would result in a twenty year after-tax, after-expenses accumu-
lation of $11,652,620. In other words, if our hypothetical benefi-
ciaries exercised the ultimate in fiscal restraint, spending none
of the proceeds and reinvesting every dollar that remained after
taxes and interest had been paid, after twenty years, they
would have approximately $11,650,000 in the bank. On the
other hand, if our hypothetical beneficiaries lacked fiscal re-
straint, they might want to seek out an investor to buy their
portfolio-*cum*-problems, and then, as the saying goes, take the
money and run. Of course, in Virginia, this is statutorily forbid-
den. Such alienation is proscribed by section 58.1-4013 of the
Code of Virginia.

However, since this is a theoretical example, with hypotheti-
cal actors, we may pursue the inquiry to its conclusion. The
conclusion of the valuation inquiry is that the fair market value
of the beneficiaries' lottery portfolio is the price that a dispas-
sionate, fully advised investor would pay to buy the portfolio
with all its problems, but promising $11,652,620 in twenty years.[165]

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164. *See, e.g.,* STEPHENS, *supra* note 116, ¶ 4.02[2]; 5 BITTKER, *supra* note 55, ¶
135.1.2. Bittker writes:
> In addition to being willing and reasonably well-informed, the parties to
> the imaginary sale are ordinarily envisioned as disembodied actors—free
> from the passions and other personal characteristics of the owner of the
> property being valued and, if the most likely buyer can be identified,
> unaffected by the latter's special characteristics.

Id.

165. There is quite respectable authority for this proposition. The Second Circuit,
in reversing and remanding a Tax Court income tax decision, wrestled with the ques-
tion of the proper valuation of a group of debtors' "securities" (scrip) used to pay
interest on bonds which they had issued. Reasoning that the scrip had value to the
extent that a market existed for it and the creditors could exchange it for cash, the
court answered the valuation question with the simple formulation of "what-you-could-
have-got-for-it-in-money-if-you-had-sold-it." Andrews v. Commissioner, 135 F.2d 314,

When inspecting the remainder interest columns of the government present worth actuarial tables for a period of twenty years at six percent (the terms used in Table 2),[166] one sees the figure of .311805. Multiplying this figure by the twenty year remainder interest of $11,652,620 yields a present value of $3,633,345. If the hypothetical investor insisted on a hedge against inflation and projected a quite modest three percent annual inflation rate over the twenty years, the factor for nine percent would be .178431[167] and the resultant present value would be $2,079,189. Since the various factors used in Table 2 do not take inflation into account, a consistent (and conservative) approach would be to assign a present value with no inflationary hedge, or $3,633,345. This is the sum required to "move" the portfolio—the amount an investor would be willing to pay *now* to acquire an illiquid instrument, whose "only" attraction is an after-tax growth to $11,652,620 twenty years hence.

There is, to be sure, a certain circular quality to these computations. If the present value of the lottery portfolio is $3,633,345 to the investor and thus establishes the fair market value, the IRS will be obliged to assess the estate tax based on this figure rather than the earlier (Table 1) values of $11,013,737 (initial calculation) or $9,301,099 (final calculation). The figures for federal estate tax, state death tax (an offset in our example), and interest would all be smaller, and the resultant net proceeds and the twenty year future value of these net proceeds would be higher than in the Table 2 computations. This in turn, would yield a present value of the portfolio *higher* than $3,633,345, which in turn would lead to *higher* estate taxes, and so on. It is beyond the scope of this article to develop an algorithm which would "zero in" on the present value of the portfolio. What does seem plain in light of the willing buyer-willing seller concept is that a present value far lower than $11,013,737 or $9,301,099 is appropriate as a true representation of fair market value. The *Andrews* court would doubtless agree.

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317 (2d Cir.), *cert. denied*, 320 U.S. 748 (1943).

166. *See* I.R.S. Pub. 1457, 3-10, Table B (Aug., 1989).

167. *Id.* at 3-18.

There is one final observation to be made before leaving the subject of valuation and that is the propriety of imputing an *after-tax* present value to the portfolio. Compensating for the effect of taxes is well established in the case law:

> In determining what they will pay for property, buyers usually take into account the taxes that will be incurred in operating the property. For example, in estimating the future net earnings of an apartment building, bidders must give the same attention to anticipated local real property taxes as to wage and utility costs.
> In valuing the stock of a corporation, it is customary to take into account not only excise and other taxes incurred in operating its business, but also the corporation's income taxes because the shareholders' return on investment consists of the after-tax earnings. Courts have taken into account special taxes to which the corporation is subject (e.g. the personal holding company tax), as well as tax benefits.[168]

Professor Bittker goes on to note that "[f]air market value is the amount the hypothetical buyer must pay to get the property, not the net amount the hypothetical seller receives after all expenses and taxes."[169] Finally, this concept applies with equal force to estate or gift taxes.[170]

Thus, the solution at the IRS level would be for the Service to acknowledge the willing buyer-willing seller determinant of price that underlies the true fair market value of the lottery "portfolio." A new Regulation addressing the problem of totally illiquid income rights and incorporating the present worth principles described in this section (as opposed to the "standard" calculations of Treasury Regulation § 20.2031-7) would be necessary. As previously mentioned, a definitive and precise valua-

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168. 5 BITTKER, *supra* note 55, ¶ 135.3.8 (citing Ambassador Apartments, Inc. v. Commissioner, 50 T.C. 236, 243 (1968), *aff'd per curiam*, 406 F.2d 288 (2d Cir. 1969) (income tax)(payroll taxes deducted in estimating net income); Obermer v. United States, 238 F. Supp. 29, 34 (D. Haw. 1964) (value of family corporation adversely affected by status as personal holding company)); Gottlieb v. Commissioner, 33 T.C.M. (CCH) 765 (1974) (income tax)(operating expenses include real estate, water, and sewer taxes).

169. 5 BITTKER, *supra* note 55, ¶ 135.3.8 (citations omitted).

170. *See* 5 BITTKER, *supra* note 55, ¶ 135.3.8 n.75 (citing Guest v. Commissioner, 77 T.C. 9, 29 (1981) (estate tax) (transfer taxes depress value)).

tion would require the development of an algorithm which could deal with the myriad of shifting variables involved.

VI. SOLUTIONS AT THE STATE LEVEL

A. "Solutions" Such as Code of Virginia § 58.1-4013 Probably not Effective

Section 58.1-4013 of the Code of Virginia (State Lottery Law) was rewritten by the 1992 General Assembly. Subsection A directs that lottery winnings are not assignable except to a deceased prize winner's designated beneficiary or estate or pursuant to a judicial order. The statute goes on to specify that "[p]ayments made according to the terms of a deceased prize winner's beneficiary designation . . . are effective by reason of the contract involved and this statute and are not to be considered as testamentary . . . ."[171] Subsection B reads:

> Investments of prize proceeds made by the Department to fund the payment of an annuitized prize are to be held in the name of the Department or the Commonwealth and not in the name of the prize winner. Any claim of a prize winner to a future payment remains inchoate until the date the payment is due under Department regulations.[172]

According to Kenneth W. Thorson, Director of the Virginia Lottery, the 1992 rewrite represented an attempt to assist the potential beneficiaries of lottery winners in prospective disputes with the IRS. The motivation was to enable the Commonwealth to retain quasi-title to the income rights until each annual payment ripened into ownership by the winner or his successor in interest. Having only "inchoate" rights but lacking true "ownership" of the future income stream, so the thinking went, the individual beneficiaries would not be subject to the estate tax on the future payments.[173]

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171. VA. CODE ANN. § 58.1-4013(A) (Repl. Vol. 1991 & Cum. Supp. 1993).
172. *Id.* § 58.1-4013(B).
173. Interview with Kenneth W. Thorson, Director of the Virginia Lottery, in Richmond, Va. (July 28, 1993).

As appealing as this line of reasoning is to winners and their potential beneficiaries, it is highly unlikely that it would withstand a challenge brought by the Service. When a player wins and subsequently accepts a lottery jackpot, his contract with the Commonwealth (through its subsidiary, the State Lottery Department) is perfected; he acquires *legal ownership* of the income rights which comprise the jackpot. These rights to a stream of future income constitute IRD, as we concluded in part II(H). By statute, he cannot assign these income rights inter vivos, but he can make testamentary disposition of them. Should the winner die before collecting all the payments, his will, the designated beneficiary form, or the Virginia intestacy statute will direct the disposition of the uncollected payments. *Legal ownership* of the remaining amounts then vests in the winner's successor(s) in interest. An ownership interest has passed from a decedent to his successor(s). That interest (IRD) is subject to the federal estate tax and, as the payments are received, to the federal income tax.

There is a line of cases which the Service would undoubtedly cite as support for the application of the federal tax laws when there is a conflict with state laws that seek to define property interests. The earliest of these cases was *Allen v. Henggeler.*[174] In this appeal of an estate tax decision, the Eighth Circuit held:

> The case was argued on the assumption that there is a conflict between the state and federal decisions. There is no room for conflict in this case. Each jurisdiction has its own field, and in that field it is supreme. That the state statutes and decisions are binding on the federal courts, as to the interest which the wife and husband have in this property, is not open to dispute . . . . In every case, the state statutes and state decisions are looked to for the purpose of determining the quantity and quality of the decedent's interest in property left by him.
> But, when that quantity and quality is found, then the federal courts must determine *whether* such interest is taxable under the federal estate tax law. It would indeed be unthinkable to hold that, under this federal taxing law, an

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174. 32 F.2d 69 (8th Cir. 1929), *cert. denied,* Henggeler v. Allen, 280 U.S. 594 (1929).

identical interest of the decedent (as determined by the state courts) should be taxed in Kansas and not in Nebraska, because the courts in the two states differently construe their own *state* inheritance tax laws.[175]

The operative word in this excerpt, for our purposes, is "whether." The state jurisdiction defines the property rights at issue; the federal courts determine "whether such interest is taxable . . . ." Section 58.1-4013 of the Code of Virginia does attempt to define the property rights of the beneficiaries, but the federal courts would adjudicate "whether" those rights could be reached by the federal estate tax.

Henggeler was followed in 1930 by an income tax case, *Lucas v. Earl*,[176] in which Justice Holmes wrote that "[t]here is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully [sic] devised . . . ."[177] Was Justice Holmes anticipating the "anticipatory arrangements" of section 58.1-4013?

In 1938, the Supreme Court decided another estate tax case, *Lyeth v. Hoey*.[178] Chief Justice Hughes wrote:

> In the instant case, the Court of Appeals applied the Massachusetts rule, holding that whether the property was received by way of inheritance depended "upon the law of the jurisdiction under which this taxpayer received it." *We think that this ruling was erroneous.* The question as to the construction of the exemption in the federal statute is not determined by local law . . . . [W]hen the contestant is an heir . . . and there is a distribution to the heir from the decedent's estate accordingly, the question whether what the heir has thus received has been "acquired by inheritance" within the meaning of the federal statute necessarily is a federal question. *It is not determined by local characterization.*

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175. *Id.* at 70-71 (first emphasis added).
176. 281 U.S. 111 (1930).
177. *Id.* at 114-15; *accord* Burnet v. Leininger, 285 U.S. 136, 142 (1932); Blair v. Commissioner, 300 U.S. 5, 11 (1937).
178. 305 U.S. 188 (1938), *overturned on other grounds*, Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted "so as to give a uniform application to a nationwide scheme of taxation." Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law.[179]

Finally, in 1940, the Supreme Court, in yet another estate tax case, *Morgan v. Commissioner*,[180] ruled:

State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed. Our duty is to ascertain the meaning of the words used to specify the thing taxed. If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law.[181]

Without further belaboring the point, it seems clear that the precedent established in these cases bodes ill for the beneficiary-taxpayer who bases his defense on section 58.1-4013.

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179. *Id.* at 193-94 (citations omitted)(emphasis added).

180. 309 U.S. 78 (1940).

181. *Id.* at 80-81 (citations omitted). In reading the Court's language referring to its duty "to ascertain the meaning of the words" and "no matter what name is given," one is reminded of a Second Circuit decision cited elsewhere in this article:

Words are invaluable instruments. But they are merely perfected pointers, substitutes for the index finger. If you point a word or finger at nothing, your pointing will not convert the nothing into something; talking of an eight-legged monkey with scales and fins will not bring such a quaint creature into existence; and if an object which you name is existent but vague, its vagueness will not vanish under the spell of the name no matter how precise.

Andrews, 135 F.2d at 317. (citations omitted).

B. *A Change in the State Lottery Department Regulations to Permit Discounted Payouts to Executors and Administrators (and to Individual Beneficiaries)*

The Virginia State Lottery Law is silent with respect to payment of lottery prizes over time as opposed to a lump sum. The State Lottery Department Regulations provide the following:

> **When prize payable over time.**
> Unless the rules for any specific on-line game provide otherwise, any cash prize of $100,001 or more will be paid in multiple payments over time. The schedule of payments shall be designed to pay the winner equal dollar amounts in each year, with the exception of the first, until the total payments equal the prize amount.[182]

This regulation is supplemented by the Virginia Lottery Director's Order 32(90):

> "Minimum Jackpot" means the minimum jackpot prize amount for matching all 6 of the 6 numbers drawn. Until changed, the minimum jackpot will be $1,000,000 paid over 20 years. The jackpot prize amount will be divided among the number of winning plays. The smallest annual pre-tax payment will be no less than $5,001. If there are multiple winners and their share falls below the annuitized cut-off level, the prize will be paid in a lump sum. The lump sum payment will be the current discounted value of the prize paid in equal installments over 20 years.[183]

These excerpts from departmental regulations and Director's Orders, together with the Code's silence on the subject, imply a delegation of authority by the General Assembly to the Lottery Director to promulgate the necessary rules in this area of the State Lottery's operations. It would seem to be a simple enough matter to authorize a discounted-to-present-value, lump sum payout to the personal representative of the decedent in those cases where the winner died before collecting the full amount of the prize.

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182. Virginia State Lottery Dept. Reg. VR 447-02-2, § 3.33 (1992).
183. Virginia Lottery Director's Order 32(90), ¶ 14 (Oct. 31, 1990).

However, according to Kenneth Thorson, there are some problems and risks associated with this solution.[184] If the payout were made in a lump sum, not only would the estate tax be due on the full amount, but income tax would apply to the lump sum on the estate's income tax return, resulting in the exposure of more of the winnings to the maximum marginal rate than would be the case if the payments were spread over a number of years. If there were multiple beneficiaries, some might feel comfortable with the "management" problem of paying the taxes and refraining from dissipating the payments in consumption. Others, however, might want to take their lump sum share, pay the (higher) taxes, and be free to use the rest as they see fit.

If the lump sum option is available to all beneficiaries, however, the Service might assess full taxes immediately on all beneficiaries under the doctrine of constructive receipt. Under this doctrine, if a taxpayer has an unqualified, vested right to receive immediate, full payment, even though she has not actually received the money, the IRS may view the money as being constructively received and impose taxes on the full amount.[185]

It would involve some risk to knowingly test the boundaries of an "unqualified, vested right," since the Service's response to any given situation is unpredictable. However, the risk could probably be minimized by the promulgation of a regulation whereby the individual beneficiaries each had to formally petition the Lottery Department in order to receive a lump sum payout. If final discretion rested with the Lottery Department, it could be persuasively argued that substantial limitations or restrictions on the beneficiaries' access to the money existed, thus barring the application of the constructive receipt principle.[186]

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184. Interview with Kenneth W. Thorson, Director of the Virginia Lottery, in Richmond, Va. (July 28, 1993).

185. *See* Treas. Reg. § 1.451-2(a) (1979).

186. *Id. See generally* Adam M. Ekonomon, *Constructive Receipt of Income*: Baxter v. Commissioner, 5 AKRON TAX J. 241 (1988) (discussing when a taxpayer constructively receives income); Judith H. O'Dell, *Income Can Be Deferred without Running the Risk of Constructive Receipt Being Applied*, 16 TAX'N FOR L. 210 (1988) (discussing the rules governing constructive receipt of income).

If such a regulation could be formulated, it would be the simplest, "cleanest" solution to the entire problem. It would be easy to promulgate, requiring only a stroke of the proverbial administrative pen. It would enable individual beneficiaries to petition the Lottery Department for a lump sum payout, while those beneficiaries willing to accept the "management" problem could elect a regulatory default option of receiving their payments over the normal twenty year period. It would avoid the probably quixotic alternative of seeking a new Treasury Regulation (with attendant algorithm). The one flaw is the lack of assurance that any such regulation would pass the Service's constructive receipt test. But again, a carefully drawn regulation, giving final discretion to the Lottery Department, would probably suffice. The Service might even be persuaded to "consult" in drafting such a regulation.

VII. (PARTIAL) SOLUTIONS AT THE INDIVIDUAL LEVEL

A. *Marital Deduction Considerations*

As trite as it may sound, one of the most effective actions a jackpot winner can take is to remain or to become married. The marital deduction shelters all amounts passing from a decedent to a surviving spouse, except for terminable interests.[187] Thus, a lottery winner can ensure that he will experience no estate tax problems by being married and having a will that directs his lottery income rights to his surviving spouse. If a lottery winner is not married, the fact of his winning, once publicized, should ensure no dearth of spousal candidates. This option does not provide universal remedies, however, as many potential winners may already be in comfortable circumstances and may wish to make their children the beneficiaries of the prize money. State laws, moreover, may foreclose the option in certain situations.[188]

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187. *See* I.R.C. § 2056(a)-(b) (1993).

188. *See* PETER N. SWISHER ET AL., FAMILY LAW: CASES, MATERIALS AND PROBLEMS 208, 218 (1990). Same sex marriages are barred by statute in virtually all states. *Id.* at 208. Statutes forbidding incestuous marriages vary in the degree of consanguinity regulated, but typically proscribe marriage to a parent, a child, or a sibling, and often extend this proscription to nieces, nephews, etc. *Id.* at 218-19.

B. *Insurance on the Lottery Winner's Life*

Life insurance can be a very effective estate planning tool and is used to manage the tax problems of large estates generally. Proceeds of a life insurance policy made payable to the decedent's beneficiaries are (with certain minor exceptions) not subject to federal income tax.[189] By placing the policy in an irrevocable life insurance trust, or by otherwise divesting herself of the "incidents of ownership"[190] of the policy, the lottery winner can ensure that the proceeds of the policy will not be subject to the estate tax.

If the lottery winner is unmarried and is determined to remain so, one possible solution is to secure single life coverage, or coverage on her life only. In the discussion of Table 1 in part I(D) we noted total death tax liability of $5,505,555. In order to fund this potential liability (mindful that income taxes will consume a large part of any given year's payout), the winner might consider a single life policy of $5,500,000. Tables 3 and 4 show the costs of providing such coverage for a male, aged fifty, and a female, aged seventy, respectively.[191]

The figures in Table 3 reflect the costs for a preferred non-smoker, i.e., one with no risk factors. The annual premium, which remains constant throughout the life of the policy, is $78,442. The policy mix is ten percent whole life and ninety percent term insurance. The three sets of statistics are current values (assuming a continuing dividend equal to that earned in July 1993), index values (dividend equal to the average of the past fifty years), and guaranteed values (no dividend). Not shown on Table 3 is the fact that current value dividends would generate cash sufficient to "vanish" the premium after seventeen years, i.e. the policy would sustain itself without further premiums beyond that point. Index value dividends would vanish the premium after the twenty-fifth year. With guaranteed values or no dividends, the premium would never vanish.

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189. *See* I.R.C. § 101(a)(1) (1993).

190. *See* Treas. Reg. § 20.2042-1(c)(2) (1979).

191. Tables provided by Lawrence W. Jarman, Jr., CLU, Vice President, TBA Associates, Richmond, Virginia (Aug. 17, 1993).

Table 3

COMPARATIVE VALUES AT CURRENT SCALE, AT INDEX,
AND GUARANTEED VALUES PREPARED FOR

CONFIDENTIAL   MALE PREFERRED NONSMOKER, AGE 50

$550000 MANULIFE FINANCIAL'S PREMIER WHOLE LIFE (1992) B84-93	
INITIAL ANNUAL PREMIUM	$11716.00
$4950000 LIFE PLUS I RIDER	$66725.99
$5500000 TOTAL INITIAL INSURANCE INITIAL ANNUAL PREMIUM	$78441.99

VALUES AT CURRENT AND AT INDEX INCLUDE BENEFITS ATTRIBUTABLE TO DIVIDENDS
GUARANTEED VALUES ASSUME THAT NO DIVIDENDS ARE PAID
AND THAT PREMIUMS ARE PAID EVERY YEAR

		CURRENT VALUES			INDEX VALUES			GUARANTEED VALUES**		
YEAR	AGE	CASH PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	TOTAL GUAR PREMIUM DUE	TOTAL GUAR CASH VALUE	TOTAL GUAR DEATH BENEFIT
1	50	78442	37571	5500001	78442	37301	5500001	78442	37058	5500001
2	51	78442	77812	5500000	78442	77061	5500000	78442	65112	5500000
3	52	78442	126085	5500000	78442	124496	5500000	78442	98876	5500000
4	53	78442	175227	5500000	78442	172384	5500001	78442	130478	5500000
5	54	78442	225407	5500000	78442	220865	5500000	78442	160876	5500000
		392210			392210			392210		
6	55	78442	276403	5500000	78442	269706	5500001	78442	187939	5500000
7	56	78442	329836	5500000	78442	320496	5500001	78442	212269	5500000
8	57	78442	386022	5500000	78442	373506	5500000	78442	235370	5500000
9	58	78442	444157	5500000	78442	427894	5500000	78442	256901	5500000
10	59	78442	504206	5500000	78442	483582	5500000	78442	276285	5500000
		784420			784420			784420		
11	60	78442	566580	5500000	78442	541011	5500000	78442	284118	5500000
12	61	78442	652827	5500000	78442	621286	5500000	78442	306802	5500000
13	62	78442	741732	5500000	78442	703143	5500000	78442	323140	5500000
14	63	78442	831808	5500000	78442	785040	5500000	78442	331717	5500000
15	64	78442	921804	5500000	78442	865701	5500000	78442	330940	5500000
		1176630			1176630			1176630		

Table 4

COMPARATIVE VALUES AT CURRENT SCALE, AT INDEX,
AND GUARANTEED VALUES PREPARED FOR

CONFIDENTIAL   FEMALE STANDARD NONSMOKER, AGE 70

$550000 MANULIFE FINANCIAL'S PREMIER WHOLE LIFE (1992) B84-93	
INITIAL ANNUAL PREMIUM	$28337.00
$4950000 LIFE PLUS I RIDER	$207900.00

$5500000 TOTAL INITIAL INSURANCE	INITIAL ANNUAL PREMIUM	$236237.00

VALUES AT CURRENT AND AT INDEX INCLUDE BENEFITS ATTRIBUTABLE TO DIVIDENDS
GUARANTEED VALUES ASSUME THAT NO DIVIDENDS ARE PAID
AND THAT PREMIUMS ARE PAID EVERY YEAR

		CURRENT VALUES			INDEX VALUES			GUARANTEED VALUES**		
YEAR	AGE	PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	TOTAL GUAR PREMIUM DUE	TOTAL GUAR CASH VALUE	TOTAL GUAR DEATH BENEFIT
1	70	236237	114545	5500000	236237	113720	5500000	236237	112815	5500000
2	71	236237	236980	5500000	236237	234750	5500000	236237	187774	5500000
3	72	236237	367317	5500000	236237	362675	5500000	236237	265652	5500001
4	73	236237	492564	5500000	236237	484429	5500000	236237	331377	5500000
5	74	236237	617385	5500000	236237	604650	5500000	236237	387295	5500000
		1181185			1181185			1181185		
6	75	236237	739519	5500000	236237	720849	5500000	236237	424487	5500000
7	76	236237	866544	5500000	236237	840569	5500000	236237	445079	5500001
8	77	236237	997414	5500000	236237	962645	5500000	236237	451822	5500000
9	78	236237	1131954	5500000	236237	1086903	5500000	236237	429917	5500000
10	79	236237	1266976	5500000	236237	1209948	5500000	236237	385656	5500001
		2362370			2362370			2362370		
11	80	236237	1404974	5500000	236237	1334591	5500000	236237	246601	5500000
12	81	236237	1657614	5500000	236237	1563464	5500000	236237	210238	4319614
13	82	*	1705897	5500000	236237	1828329	5500000	236237	229339	3200032
14	83	*	1770551	5500000	236237	2119214	5500000	236237	247935	2906323
15	84	*	1841354	5500000	236237	2435245	5500000	236237	266008	2648574
		2834844			3543555			3543555		

Table 4, as mentioned, shows the data for a seventy year old female. The figures reflect the costs for a "standard" nonsmoker, i.e., one with some risk factors. The policy mix is the same, ten percent whole life and ninety percent term. As might be expected, the annual premium is significantly higher, $236,237 for the life of the policy. Here, the current value dividend vanishes the premium after the twelfth year and the index value dividend does so after the fifteenth year. Although an annual

insurance premium of almost a quarter million dollars seems high, a seventy year old must weigh this cost against the statistical probability of dying before collecting the full lottery jackpot and thereby leaving a large tax problem for her beneficiaries.

C. *Survivorship Insurance*

If the lottery winner is married and intends to leave the income rights to her surviving spouse, there will be no estate tax at the first death. There will be an estate tax problem at the death of the surviving spouse, however, and this problem can be addressed with survivorship, or second-to-die, insurance. Tables 5 and 6 show the details of such coverage, again with $5,500,000 policies and the same ten percent-ninety percent mix.

Table 5

COMPARATIVE VALUES AT CURRENT SCALE, AT INDEX, AND GUARANTEED VALUES PREPARED FOR

MR. CONFIDENTIAL
MALE PREFERRED NONSMOKER, AGE 50

MRS. CONFIDENTIAL
FEMALE PREFERRED NONSMOKER, AGE 50

$550000 MANULIFE FINANCIAL'S SURVIVORSHIP SE B84-93	
INITIAL ANNUAL PREMIUM	$5875.00
$4950000 LIFE PLUS I RIDER	$31927.50
$5500000 TOTAL INITIAL INSURANCE INITIAL ANNUAL PREMIUM	$37802.50

VALUES AT CURRENT AND AT INDEX INCLUDE BENEFITS ATTRIBUTABLE TO DIVIDENDS
ESTATE PRESERVATION BENEFIT OF $4,500,000** IS INCLUDED IN THE FIRST 4 YEARS

GUARANTEED VALUES ASSUME THAT NO DIVIDENDS ARE PAID
AND THAT PREMIUMS ARE PAID EVERY YEAR

	CURRENT VALUES			INDEX VALUES			GUARANTEED VALUES**		
YEAR	CASH PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	CASH PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	TOTAL GUAR PREMIUM DUE	TOTAL GUAR CASH VALUE	TOTAL GUAR DEATH BENEFIT
1	37803	12977	10000000	37803	12830	10000000	37803	12744	10000000
2	37803	26698	10000001	37803	26243	10000000	37803	25884	10000000
3	37803	45288	10000001	37803	44327	9999999	37803	43475	10000000
4	37803	65709	10000000	37803	63993	10000001	37803	62288	10000000
5	37803	87292	5500000	37803	84542	5500000	37803	81602	5500000
	189013			189013			189013		
6	37803	110242	5500000	37803	106137	5500001	37803	101314	5500000
7	37803	134594	5500000	37803	128785	5500000	37803	121325	5500000
8	37803	160518	5500000	37803	152610	5500000	37803	141572	5500000
9	37803	188204	5500000	37803	177759	5500000	37803	161961	5500000
10	37803	217832	5500000	37803	204356	5500000	37803	182363	5500000
	378025			378025			378025		
11	37803	249792	5500000	37803	232733	5500000	37803	201761	5500000
12	37803	284374	5500000	37803	263100	5500001	37803	220417	5500000
13	37803	323870	5500000	37803	297836	5500000	40690	243708	5500000
14	37803	369365	5500000	37803	337805	5500000	40690	268931	5500000
15	37803	421340	5500000	37803	383368	5500000	40690	295605	5500000
	567038			567038			575700		

Table 6

COMPARATIVE VALUES AT CURRENT SCALE, AT INDEX,
AND GUARANTEED VALUES PREPARED FOR

MR. CONFIDENTIAL   MRS. CONFIDENTIAL
MALE STANDARD NONSMOKER, AGE 70   FEMALE STANDARD NONSMOKER, AGE 70

$550000 MANULIFE FINANCIAL'S SURVIVORSHIP SE B84-93
         INITIAL ANNUAL PREMIUM $19916.52
$4950000 LIFE PLUS I RIDER $137907.03

$5500000 TOTAL INITIAL INSURANCE   INITIAL ANNUAL PREMIUM $157823.56

VALUES AT CURRENT AND AT INDEX INCLUDE BENEFITS ATTRIBUTABLE TO DIVIDENDS
ESTATE PRESERVATION BENEFIT OF $4,500,000** IS INCLUDED IN THE FIRST 4 YEARS

GUARANTEED VALUES ASSUME THAT NO DIVIDENDS ARE PAID
AND THAT PREMIUMS ARE PAID EVERY YEAR

	CURRENT VALUES			INDEX VALUES			GUARANTEED VALUES**		
YEAR	CASH PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	CASH PREMIUM DUE	TOTAL CASH VALUE	TOTAL DEATH BENEFIT BEG OF YR	TOTAL GUAR PREMIUM DUE	TOTAL GUAR CASH VALUE	TOTAL GUAR DEATH BENEFIT
1	157824	57649	10000000	157824	57005	10000000	157824	55826	10000000
2	157824	126414	10000000	157824	124386	9999999	157824	119502	10000000
3	157824	209197	10000000	157824	204875	9999999	157824	192822	10000000
4	157824	293836	10000000	157824	286193	10000000	157824	262154	10000000
5	157824	379915	5500000	157824	367856	5500000	157824	326111	5500000
	789118			789118			789118		
6	157824	466698	5500001	157824	449051	5500000	157824	380463	5500000
7	157824	554043	5500001	157824	529599	5500000	157824	421175	5500001
8	157824	641153	5500000	157824	608623	5500000	157824	446736	5500000
9	157824	727514	5500000	157824	685574	5500000	157824	451084	5500000
10	157824	811504	5500000	157824	758731	5500000	157824	431784	5500000
	1578235			1578235			1578235		
11	*	749838	5500000	157824	851348	5500000	157824	335942	5500001
12	*	705120	5500000	157824	966491	5500000	157824	181176	5500000
13	*	694551	5500000	*	955141	5500000	167729	192247	1949195
14	*	713638	5500000	*	972691	5500000	167729	209501	1787571
15	*	757983	5500000	*	1014851	5500001	167729	224582	1755740
	1578235			1893882			2397070		

Table 5 depicts a survivorship policy for two persons, male and female, both aged fifty, and both preferred nonsmokers. The annual premium is $37,803. In order to keep the policy in force, the surviving spouse must continue to pay the premiums after the first death, since the insurance protection is for two lives. If dividends are paid at current values, the premium will vanish after the seventeenth year. If paid at the index, or fifty year average, the premium will vanish after thirty-five years.

Table 6 portrays a survivorship policy for two persons, male and female, both aged seventy, and both "standard" nonsmokers. The annual premium, again as would be expected, is significantly higher, $157,824. At current value dividends, the premium vanishes after the tenth year. At index value dividends, the premium vanishes after twelve years.

The premium for the survivorship policy for two fifty year olds is forty-eight percent of the cost of the single life policy for the fifty year old man alone. The premium for the seventy year old couple's survivorship policy is sixty-seven percent of the cost of a single life policy for the seventy year old woman alone. These percentages reflect the statistical likelihood that two persons will live longer than one, i.e., the survivor of a couple will outlive a single person, age and health being equal. Thus, there is an economic incentive to be married, as well as the previously-discussed tax incentive.

VIII. CONCLUSION AND RECOMMENDATIONS

The first and perhaps overriding conclusion is that the estate of a deceased lottery winner does indeed have a tax problem. There are two distinguishing factors which may serve to make the problem more acute for the lottery winner's estate than for other large estates. As noted, the income rights in the hands of the lottery winner's beneficiaries are illiquid and, except for the yearly payouts, are not available to pay estate taxes. The second factor to take into account is that, while most large estates are usually amassed over a period of many years, with ample time for estate planning lawyers to develop appropriate strategies, the estate of a deceased lottery winner may literally be an overnight phenomenon. In such situations, the decedent's per-

sonal representative may lack the time or knowledge to develop a tax-minimizing and beneficiary-satisfying strategy.

Having acknowledged the existence of the problem, the next conclusion is that the problem, far from being the insoluble one initially portrayed by NAASPL, is susceptible to a solution. Properly managed, the problem becomes the proverbial opportunity—a $20 million jackpot can yield almost $8 million in after-tax and after-expense proceeds, and if reinvested, can grow to $11.65 million at the end of the twenty-year period.

In reviewing the tax treatment of other income streams left by a decedent, it seems that the Code and the case law are consistent in applying the IRD and present value concepts to these streams. The Regulations, however, prescribe that "standard" actuarial tables be used to compute present value, and only grudgingly acknowledge that some discount for illiquidity may be appropriate. The case law, in contrast, recognizes discounts in a wide array of situations, with amounts sometimes approaching ninety percent. State death and income tax statutes play a large role in developing a strategy, and the state-by-state disparity makes it imperative to carefully research the state codes in jurisdictions where the decedent owned property.

The range of possible solutions to the problem gives rise to a number of recommendations. At the congressional level, a new Code section should be enacted which explicitly recognizes the inequity of imposing estate taxes on income rights which yield cash only over a period of (possibly) many years. If lottery payments are receivable only over twenty years, the Code should recognize this by permitting payment of the estate tax, with interest, over twenty years as well.

Failing the enactment of a new Code section, the Service should promulgate a new Regulation which takes the illiquidity of the lottery income rights into account and permits a realistic discount for nonmarketability. The willing buyer-willing seller price discussed in part V, is clearly a small fraction of the present value determined through government actuarial tables. The resulting lower estate tax and lower interest suggest that a

fairly sophisticated algorithm[192] would be needed to account for back-and-forth adjustments.

At the state level, attempts to "define away" the problem will likely be unavailing if a future litigant relies on state statutes enacted for this purpose. Much more promising is a relatively simple change in state lottery regulations permitting a discounted, lump sum payout upon approval of a proper petition to the State Lottery Department.

Individual winners can do much by way of self-help. The starting point is knowledge and information. To this end, the services of a competent estate planning attorney are indispensable. Individual winners can do much to ameliorate the problem potentially facing their beneficiaries by marrying or remaining married, so as to reap the advantages of the marital deduction. They can purchase life insurance, either single life or survivorship, which may solve the estate tax problem completely. Such insurance is not inexpensive, but, in this situation, may be a bargain. Not all winners will be insurable and premiums will vary directly as a function of age. Therefore, individual factors will likely drive the insurance decision.

In sum, the "lottery problem" has a solution—in fact a number of possible solutions. NAASPL and the various state lottery departments should consider the options presented in

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192. The author acknowledges two areas in which future research could more precisely quantify the findings of this paper. The first is the algorithm discussed in part V which would "zero in" on the present value of the "lottery portfolio." This problem is analogous to the vastly more simple example of "net gifts," in which the donor stipulates that the donee pay the gift tax. In that case, the tentative tax is computed on the full fair market value of the gift and this tentative tax is then adjusted downwards by dividing by 1.00 plus the tax rate. See Rev. Rul. 75-72, 1975-1 C.B. 310. Lacking such an algorithm, one possibility would be to present all the facts to the Service and request that they compute the tax.

The second area that would benefit from research involves the fact that the Table 2 (part I(D)) combined federal/state income tax rate of 35% has not been updated to reflect the new (post 1993 budget bill) maximum federal rate of 39.6%. As discussed earlier, the combination of the 39.6% federal rate and the maximum Virginia rate of 5.75% yields a total rate of 45.35%, more than ten percentage points higher than in the Table 2 illustration. See supra note 40. The author expresses the hope that NAASPL and Brown, Winick, Graves, Donnelly, Baskerville and Schoenebaum might be able to update Table 2 to reflect this substantial increase. See supra note 23. The "management" problem would increase in difficulty, thus making the case for reform even more compelling than portrayed in this analysis.

this article, and, if appropriate, undertake a unified, coordinated strategy. Until solutions at this level are effected, individual lottery winners, individual beneficiaries, and individual estate planning practitioners should carefully consider the tax implications and possible tax strategies outlined in this article.

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